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CONFLICTS AND OPPORTUNITIES FOR PENSION FIDUCIARIES IN THE ESG ENVIRONMENT

SUSAN N. GARY*

I. Introduction

Acting as prudent investors, pension managers must consider material factors[1] that affect the risk and return profile of funds. Material environmental, social, and governance ("ESG") factors may affect financial performance by identifying opportunities and risks, so it would seem prudent to consider those factors when making decisions in the best interests of plan beneficiaries. As interest in ESG investing and funds identified as ESG funds has grown,[2] old questions about fiduciary duties and ESG investing have surfaced.[3]

On June 30, 2020, the Department of Labor ("DOL") issued a proposed rule[4] ("2020 Proposed Rule") with the apparent goal of curtailing consideration of ESG factors.[5] The DOL then received a deluge of negative comments from the financial industry, the pension industry, and

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1. Prudence is defined by process because consideration of "all" financially material factors is impossible, but a prudent investor makes an effort to consider known and knowable factors.

2. *See* Quinn Curtis, Jill Fisch & Adriana Z. Robertson, *Do ESG Mutual Funds Deliver on Their Promises?*, 120 MICH. L. REV. 393, 395 (2021) ("ESG investing—that is, investing informed by environmental, social, and governance criteria or considerations—is growing explosively."); *see also id.* at 395 nn.2–7 (citing news articles discussing trends in ESG investing).

3. Max M. Schanzenbach & Robert H. Sitkoff, *Reconciling Fiduciary Duty and Social Conscience: The Law and Economics of ESG Investing by a Trustee*, 72 STAN. L. REV. 381, 384–85 (2020).

4. Financial Factors in Selecting Plan Investments, 85 Fed. Reg. 39113 (proposed June 30, 2020).

5. *See id.* The 2020 Proposed Rule singled out ESG factors for additional documentation. *See infra* Section IV.E.

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individuals, pointing out that compliance with the guidance would adversely affect the financial interests of plan participants.[6] The DOL responded by walking back the proposed changes, issuing a final rule[7] ("2020 Rule") that, in most respects, reaffirms long-standing guidance on investment duties in the Employee Retirement Income Security Act of 1974 ("ERISA") context.[8]

After the inauguration of President Joe Biden in January 2021 and the change in administration, the DOL announced that it would not enforce the 2020 Rule until it published further guidance.[9] In May 2021, President Biden directed the Secretary of Labor to consider rescinding the 2020 Rule and to develop guidance addressing the effects of climate risk on pension investments.[10] On October 14, 2021, the DOL issued a proposed rule, Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights ("2021 Proposed Rule").[11] The comment period ran for sixty days,[12] and at the time this Article is being written, the DOL is considering hundreds of submitted comments. Direct guidance from the DOL remains in flux, but the underlying duties of pension fiduciaries have not changed. Pension fiduciaries should consider and evaluate investment products and strategies based on current standards of prudent investment.

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6. *Final ERISA Rules Circle Back to Allow ESG Investing*, REINHART BOERNER VAN DEUREN (Nov. 17, 2020), https://www.reinhartlaw.com/knowledge/final-erisa-rules-circle-back-to-allow-esg-investing; *US SIF, Investor Organizations and Financial Industry Firms' Analysis of Public Comments on Department of Labor ESG Proposal Shows Landslide of Opposition*, US SIF (Aug. 20, 2020, 1:11 PM), https://www.ussif.org/blog_home.asp?display=148 [hereinafter *US SIF, Investor Organizations and Financial Industry Firms' Analysis of Public Comments*].

7. Financial Factors in Selecting Plan Investments, 85 Fed. Reg. 72846 (Nov. 13, 2020) (to be codified at 29 C.F.R. pts. 2509, 2550).

8. *See id.*

9. Emp. Benefits Sec. Admin., U.S. Dep't of Labor, U.S. Department of Labor Statement Regarding Enforcement of Its Final Rules on ESG Investments and Proxy Voting by Employee Benefit Plans (Mar. 10, 2021), https://www.dol.gov/sites/dolgov/files/ebsa/laws-and-regulations/laws/erisa/statement-on-enforcement-of-final-rules-on-esg-investments-and-proxy-voting.pdf [hereinafter Department of Labor Statement Regarding Enforcement of Its Final Rules]; News Release, Emp. Benefits Sec. Admin., U.S. Dep't of Labor, US Department of Labor Releases Statement on Enforcement of Its Final Rules on ESG Investments, Proxy Voting by Employee Benefit Plans (Mar. 10, 2021), https://www.dol.gov/newsroom/releases/ebsa/ebsa20210310; *see infra* Section IV.F.

10. Exec. Order No. 14,030, 86 Fed. Reg. 27967 (May 20, 2021).

11. Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights, 86 Fed. Reg. 57272 (Oct. 14, 2021) (to be codified at 29 C.F.R pt. 2550).

12. *Id.*

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Prudent investors consider financially material information, including financially material ESG factors.[13]

Part II of this Article describes the fiduciary duties, derived from the statutory language of ERISA and from the common law of trusts, that apply to pension managers.[14] Part III briefly explains the history of social investing and, based on that history, finds reasons for the continuing suspicion that ESG investing necessitates a financial cost to the portfolio.[15] Part IV of the Article then reviews and analyzes the DOL guidance on fiduciary investing from 1994 through the present.[16] Part V discusses cautions and opportunities for pension fiduciaries under current legal rules and guidance.[17] The Article concludes by wondering whether a pension fiduciary should consider plan participants' interests beyond financial interests.[18]

II. Fiduciary Duties for Pension Managers

Pension managers act as fiduciaries when they make decisions for the funds they manage.[19] Congress enacted ERISA in 1974 to provide minimum standards for most pension plans operating in private industry, and ERISA outlines fiduciary duties for plans governed by ERISA.[20] State law defines the fiduciary duties that apply to other pension plans.[21] Fiduciary duties protect plan participants by constraining and guiding the

13. In the news release describing the 2021 Proposed Rule, Acting Assistant Secretary for the Employee Benefits Security Administration Ali Khawar explained, "A principal idea underlying the proposal is that climate change and other ESG factors can be financially material and when they are, considering them will inevitably lead to better long-term risk-adjusted returns, protecting the retirement savings of America's workers." News Release, Emp. Benefits Sec. Admin., U.S. Dep't of Labor, US Department of Labor Proposes Rule to Remove Barriers to Considering Environmental, Social, Governance Factors in Plan Management (Oct. 13, 2021), https://www.dol.gov/newsroom/releases/ebsa/ebsa20211013.

14. *See infra* Part II.

15. *See infra* Part III.

16. *See infra* Part IV.

17. *See infra* Part V.

18. *See infra* Part VI.

19. Employee Retirement Income Security Act of 1974, § 403, 29 U.S.C. § 1103(a).

20. *See id.* § 404, 29 U.S.C. § 1104.

21. *See* David H. Webber, *The Use and Abuse of Labor's Capital*, 89 N.Y.U. L. REV. 2106, 2109–10 (2014) (describing state law application to public pension plans). This Article focuses on ERISA's articulation of fiduciary duties. As Webber points out, many state pension laws adapt ERISA's fiduciary standard. *Id.*

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managers in the choices they make for the plans. Understanding how fiduciary duties apply to pension managers can alleviate some concerns managers may have and can point to opportunities in investment strategies.

When Congress adopted ERISA in 1970, it adopted a trust standard for pensions, stating that pensions are held "in trust."[22] Some differences in terminology between ERISA and trust law exist, which have led to confusion over the years.[23] In general, however, the fiduciary duties that apply to pensions can be understood by reference to trust law. Indeed, as Professors Daniel Fischel and John Langbein have pointed out, "By mandating the trust form and transposing the duty of loyalty to pension law, the drafters of ERISA were able to institute a familiar regime to protect pension funds against internal defalcation."[24] The Supreme Court has confirmed that an ERISA fiduciary's duty is "derived from the common law of trusts."[25]

A. Exclusive Benefit Rule Under ERISA–Duty of Loyalty Under Trust Law

In trust law, the duty of loyalty is the duty to act in the sole interest of the beneficiaries whose interests the fiduciary serves.[26] Rather than using the term "duty of loyalty," ERISA adopted what is referred to as the exclusive benefit rule. The exclusive benefit rule is found in section 404(a)(1) of ERISA:

> [A] fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and—
>
> (A) for the exclusive purpose of:
>
> (i) providing benefits to participants and their beneficiaries; and
>
> (ii) defraying reasonable expenses of administering the plan;
>
> (B) with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a

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22. Employee Retirement Income Security Act of 1974, § 403, 29 U.S.C. § 1103(a).

23. Daniel Fischel & John H. Langbein, *ERISA's Fundamental Contradiction: The Exclusive Benefit Rule*, 55 U. CHI. L. REV. 1105, 1107–10 (1988) (describing how elements of trust law have been imported into ERISA law).

24. *Id.* at 1110.

25. Tibble v. Edison Int'l, 135 S. Ct. 1823, 1828 (2015).

26. RESTATEMENT (THIRD) OF TRUSTS § 78 (AM. L. INST. 2007).

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> like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims;
>
> (C) by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so; and
>
> (D) in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of this subchapter and subchapter III.[27]

The purpose of the duty of loyalty—and of the exclusive benefit rule—is to require the fiduciary to focus on the interests of the persons for whom the fiduciary is investing and not on the fiduciary's own personal interests.[28] The duty of loyalty reflects the need to protect the persons for whom the fiduciary is making decisions from the adverse consequences that could result from fiduciary conflicts of interest and self-dealing.[29] Because the fiduciary is in a position to gain private benefit and has limited oversight, the fiduciary duties developed to protect the trust's beneficiaries.[30] Although the focus of the duty of loyalty is on conflicts of interest, the duty also prohibits the fiduciary from placing the fiduciary's own interests or preferences above those of the beneficiaries, even if the fiduciary will not benefit financially.[31]

In the context of a pension, both the duty of loyalty and the exclusive benefit rule mean that the fiduciary must focus on the interests of the plan participants and their beneficiaries. Although "interests" and "benefits" are not defined in ERISA or in trust law, in the pension context, they have been interpreted to mean exclusively financial benefits.[32] The 2020 Rule continues to apply this interpretation of interests.[33] A pension manager cannot make investment choices that result in a financial cost to the plan,

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27. Employee Retirement Income Security Act of 1974, § 404(a)(1), 29 U.S.C. § 1104(a)(1).

28. *See* RESTATEMENT (THIRD) OF TRUSTS § 78 cmt. b.

29. *Id.*

30. SUSAN GARY ET AL., BOGERT'S THE LAW OF TRUSTS AND TRUSTEES § 543 (2022).

31. *See* RESTATEMENT (THIRD) OF TRUSTS § 78 cmt. f.

32. *See, e.g.*, Fifth Third Bancorp v. Dudenhoeffer, 134 S. Ct. 2459, 2468 (2014).

33. Financial Factors in Selecting Plan Investments, 85 Fed. Reg. 72846, 72884 (Nov. 13, 2020) (to be codified at 29 C.F.R. § 2550.404a1(c)).

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even if the choices bring other, non-financial benefits.[34] While a private investor might decide to take a lower financial return or more risk in exchange for other benefits, a fiduciary investing pension funds cannot make the same decision. Over the years, the DOL guidance has consistently focused on financial risk and return, as discussed in Part IV below.

B. Duty of Care–The Prudent Investor Standard

At the time of ERISA's enactment, modern portfolio theory had begun to influence both investment strategies and the prudent investor standard in trust law.[35] ERISA's direction that a fiduciary should diversify investments to minimize risks reflects the influence of modern portfolio theory.[36] Further, ERISA instructs the fiduciary to act "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims."[37] This guidance embraces the evolving nature of the prudence standard and has allowed the ERISA standard, like the trust standard on which it is based, to evolve.

The prudent man standard[38] in trust law began as a conservative, asset-by-asset analysis that limited financial risk and, by doing so, limited

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34. *Id.*

35. Harry Markowitz published his explanation of modern portfolio theory in 1952, arguing that a diversified portfolio in which an investor analyzed risk-return characteristics across the portfolio rather than on an asset-by-asset basis could reduce overall risk. Markowitz emphasized diversification as a way to manage risk. *See* Harry Markowitz, *Portfolio Selection*, 7 J. FIN. 77 (1952); *see also* John H. Langbein, *The Uniform Prudent Investor Act and the Future of Trust Investing*, 81 IOWA L. REV. 641, 642 (1996) (describing the influence of modern portfolio theory on the development of the Uniform Prudent Investor Act).

36. BEVIS LONGSTRETH, MODERN INVESTMENT MANAGEMENT AND THE PRUDENT MAN RULE 33–35 (1987); Stephen P. Johnson, Note, *Trustee Investment: The Prudent Person Rule or Modern Portfolio Theory, You Make the Choice*, 44 SYRACUSE L. REV. 1175, 1184 (1993).

37. Employee Retirement Income Security Act of 1974, § 404(a)(1)(B), 29 U.S.C. § 1104(a)(1)(B).

38. The prudent man standard became the prudent person standard and then the prudent investor standard. *See* Langbein, *supra* note 35, at 645 ("As did the 1992 Restatement, the Act takes the opportunity to unisex the prudent man, who has now become the prudent investor.").

financial reward.[39] That standard evolved to become the prudent investor standard, which incorporated modern portfolio theory, and which has been adopted by statute or case law throughout the country.[40] A prudent person making investment decisions for a pension plan today would follow the circumstances prevailing now and not those in 1974. These circumstances, in trust law and under ERISA, increasingly include an understanding of the role material ESG factors can play in financial analysis.[41]

The prudent investor standard does not require particular types of investments or particular investment strategies. A prudent investor looks at industry norms and learns from what other prudent investors are doing.[42] As industry norms embrace the use of material ESG factors, not as a particular investment strategy but rather as additional material information to use in making investment decisions, attention on how pension fiduciaries should consider ESG factors has increased.[43] The 2020 Rule reflects this attention.

For pension fiduciaries, the underlying duty to act as a prudent investor, in the interests of plan participants and their beneficiaries, has remained constant. But as prudent investors use new information and new strategies to improve results, the way to invest as a prudent investor would invest continues to evolve. As the preamble to the 2020 Rule explains, "[T]he Department did not intend the reference to 'generally accepted investment theories' to foreclose ERISA fiduciaries from considering emerging

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39. *Id.* at 643–45; Susan N. Gary, *Values and Value: University Endowments, Fiduciary Duties, and ESG Investing*, 42 J. COLL. & U.L. 247, 255–58 (2016) (describing the evolution of the prudent investor standard in American trust law) [hereinafter Gary, *Values and Value*].

40. UNIF. PRUDENT INV. ACT, Prefatory Note (UNIF. L. COMM'N 1994).

41. *See* Webber, *supra* note 21, at 2174–75.

42. *See* Langbein, *supra* note 35, at 654–61 (describing the future of trust investing by discussing empirical evidence and other learning concerning modern portfolio theory, the theory of efficient markets, international investing, derivatives, and other then-current developments in thinking about investments).

43. For example, the Pension Research Council's 2021 symposium focused on sustainable investments in retirement plans. *2021 Online Symposium: Sustainable Investment in Retirement Plans: Challenges and Opportunities*, PENSION RSCH. COUNCIL: WHARTON U. PA. (Apr. 29-30, 2021), https://pensionresearchcouncil.wharton.upenn.edu/2021-online-symposium-sustainable-investment-in-retirement-plans/. *Pensions & Investments* also published a white paper in connection with a webinar, "ESG: Focus on Climate Change," held on June 30, 2021. P&I Content Solutions, *ESG: Climate Change: The Inescapable Opportunity*, PENSIONS & INVS. (June 28, 2021), https://www.pionline.com/ESGclimateReport2021.

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theories regarding prudent investment practices or otherwise freeze investment practice as of the date of the rule."[44]

C. Duty of Impartiality

Although ERISA does not specifically call out the duty of impartiality, a fiduciary managing a pension plan providing benefits to participants and their beneficiaries must act impartially with respect to all participants and beneficiaries and to others with interests in the plans. In 1988, Daniel Fischel and John Langbein advocated incorporating the duty of impartiality into any analysis of the fiduciary duties of pension plan managers.[45] In 1996, the United States Supreme Court recognized that the duty of impartiality applies to ERISA fiduciaries.[46] The Court explained that, while not always determinative, the common law of trusts informs an interpretation of fiduciary duties under ERISA.[47] The Court stated, "The common law of trusts recognizes the need to preserve assets to satisfy future, as well as present, claims and requires a trustee to take impartial account of the interests of all beneficiaries."[48]

The duty of impartiality is the duty to treat all the people to whom a fiduciary owes duties fairly.[49] A challenge in the ERISA context is that ERISA's exclusive benefit rule appears to extend only to the participants and their beneficiaries, even though others may have interests in a plan's financial viability.[50] Employers, as well as employees, may have an interest in the plan; therefore, shareholders may be concerned about the management of the plan.[51] In a defined benefit plan, the participants will receive their benefit regardless of the investment returns the plan generates, so the employer's shareholders bear the risk of underperformance.[52] An employer benefits if the pension benefits provided to workers reduce employment costs, either because workers are willing to accept lower

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44. Financial Factors in Selecting Plan Investments, 85 Fed. Reg. 72846, 72858 (Nov. 13, 2020) (to be codified at 29 C.F.R. pts. 2509, 2550).

45. *See* Fischel & Langbein, *supra* note 23, at 1107.

46. Varity Corp. v. Howe, 516 U.S. 489, 514–15 (1996).

47. *Id.* at 497.

48. *Id.* at 514.

49. RESTATEMENT (THIRD) OF TRUSTS § 79 cmt. b (AM. L. INST. 2007).

50. *See* Fischel & Langbein, *supra* note 23; Alvin D. Lurie, *ETIs: A Scheme for the Rescue of City and Country with Pension Funds*, 5 CORNELL J.L. & PUB. POL'Y 315, 332 (1996).

51. *See* Fischel & Langbein, *supra* note 23, at 1118, 1121–22.

52. *Id.* at 1121.

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salaries in exchange for benefits or because there is less worker turnover due to worker satisfaction.[53] Either way, investment results concern the employer as well as the employees. In a defined contribution plan, the risk is borne by the participants.[54] But in either type of plan, the interests of the participants will not all be the same. Differences exist between younger and older workers, between participants who are currently employed and those who are already retired, and between workers at different salary levels.[55]

In a pension, the duty of impartiality certainly extends both to participants currently receiving benefits and to participants who will receive distributions in the future. Plan administrators must be able to make current distributions while safeguarding the plan's overall viability to protect the distributions that will be made many years later. Thus, the fiduciary's duty of impartiality is linked to the duty to act as a prudent investor. As the *Restatement of Trusts* explains, to comply with the prudent investor standard, the fiduciary must "conform to the fundamental fiduciary duties of loyalty . . . and impartiality."[56] The fiduciary should evaluate long-term risk to avoid shortchanging future distributees. Given the long-term nature of pension plans, short-term thinking and short-term investment strategies raise serious concerns.

Strategies maximizing short-term returns are tempting.[57] Fund managers may be rewarded based on quarterly returns, and business managers may be compensated based on how the company is performing a year or a quarter at a time. One might assume that future retirees will benefit from successive short time horizons, but as economists James Hawley and Jon Lukomnik[58] explain, "[T]he long-term is not simply additive short-term intervals, each of which is unrelated to the previous and the next. Rather it is the linkages of various past and current events to future ones."[59] Investments in each

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53. *See id.* at 1118.

54. *Id.* at 1124–25.

55. *Id.* at 1120–22; Lurie, *supra* note 50, at 331.

56. RESTATEMENT (THIRD) OF TRUSTS § 90(c)(1) (AM. L. INST. 2007).

57. *See generally* JON LUKOMNIK & JAMES P. HAWLEY, MOVING BEYOND MODERN PORTFOLIO THEORY 48 (2021).

58. James P. Hawley is Professor Emeritus School of Economics and Business Administration, Saint Mary College of California, and Senior ESG Advisor, Truvalue Labs, a Factset company. *Id. at ix.* Jon Lukomnik is managing partner of Sinclair Capital and a Senior Fellow at the High Meadows Institute. *Id.*

59. Jim Hawley & Jon Lukomnik, *The Long and Short of It: Are We Asking the Right Questions? Modern Portfolio Theory and Time Horizons*, 41 SEATTLE U.L. REV. 449, 472

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short-term period affect the next short-term period, and so on into the future. If long-term systemic risk has consequences for investors,[60] fiduciaries who ignore material long-term information may be violating their duty to be prudent investors and their duty to act impartially.

D. Obedience

In a pension plan, the duty of obedience aligns with the duty to be a prudent investor and the duty of loyalty.[61] The purpose of a pension is to provide distributions to participants when they retire. Acting in obedience to that purpose means that the fiduciary must invest for the financial health of the plan, including its long-term viability.

III. Historical Context for ESG Investing

A. Increasing Interest in ESG Investing

The 2020 Rule reflects an increasing interest in ESG investing and an increasing pressure on pension managers to pay attention to ESG factors.[62] As discussed below, the DOL may have been influenced by concerns voiced by some in the oil, gas, and coal industries that a focus on ESG investing was hurting those industries.[63] As originally proposed, the guidance appeared to be an attempt to chill increased use of ESG factors.[64]

(2018) (explaining that modern portfolio theory has led to an increase in shorter investment time frames).

60. *See* LUKOMNIK & HAWLEY, *supra* note 57, at 48–54 (describing short-termism and the problems caused by short-termism in investing).

61. The duty of obedience is the duty to act in compliance with the terms of the trust, and in the case of a pension it is the duty to act for the purposes of the pension. *See* RESTATEMENT (THIRD) OF TRUSTS § 76 (AM. L. INST. 2007). The duty of obedience is also the duty to comply with any laws that apply to the property being managed. *Id.*

62. Financial Factors in Selecting Plan Investments, 85 Fed. Reg. 72846, 72847 (Nov. 13, 2020) (to be codified at 29 C.F.R. pts. 2509, 2550) ("Available research and data show a steady upward trend in use of the term 'ESG' among institutional asset managers, an increase in the array of ESG-focused investment vehicles available, a proliferation of ESG metrics, services, and ratings offered by third-party service providers, and an increase in asset flows into ESG funds. This trend has been underway for many years, but recent studies indicate the trajectory is accelerating.").

63. *See infra* text accompanying notes 155–57.

64. Industry observers noted that the 2020 Rule did, indeed, have a chilling effect after it was announced. Brian Croce, *DOL Working on Additional ESG, Lifetime Income Guidance, Rules*, PENSIONS & INVS. (Apr. 29, 2021, 2:13 PM), https://www.pionline.com/regulation/dol-working-additional-esg-lifetime-income-guidance-rules (quoting Ali Khawar,

To do so, the 2020 Proposed Rule relied on an unsubstantiated assumption that using ESG factors would result in lower financial returns for the pension plan.[65] The comment letters from the finance industry countered this assumption,[66] but the idea that involving ESG information in any investment vehicle will result in a financial cost to the product or plan persists, despite evidence to the contrary. A brief look at the history of what has been called "social investing" can help explain misconceptions about ESG investing that affect fiduciaries.

Before turning to the history, it is also useful to note that any fiduciary analysis of ESG investing faces a problem with terminology. In recognition of this problem, the DOL said, in explaining the purpose for its 2020 regulatory action, 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."[67] Note that by lumping these terms together, the DOL listed ESG with non-financial performance metrics, creating further confusion around whether ESG factors are financial or non-financial. Although in its explanations of the 2020 Rule the DOL discusses ESG investing, in the 2020 Rule itself, the DOL uses the terms "pecuniary" and "non-pecuniary" and avoids using the term ESG altogether.[68]

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acting assistant secretary for EBSA as saying that "the rules had a chilling effect on investment behavior"); Alan Goforth, *DOL Halts Enforcement of Final Rule on ESG Investments*, BENEFITSPRO (Mar. 10, 2021, 5:11 PM), https://www.benefitspro.com/2021/03/10/labor-department-halts-enforcement-of-final-rules-on-esg-investments-proxy-voting-by-employee-benefit-plans/?slreturn=20210606155446.

65. Financial Factors in Selecting Plan Investments, 85 Fed. Reg. 39113, 39115 (proposed June 30, 2020) ("Moreover, ESG funds often come with higher fees, because additional investigation and monitoring are necessary to assess an investment from an ESG perspective.").

66. *See Final ERISA Rules Circle Back to Allow ESG Investing*, *supra* note 6; Jon Lukomnik, *Comment Letter on Proposed Regulation of ESG Standards in ERISA Plans*, HARV. L. SCH. F. ON CORP. GOVERNANCE (July 21, 2020), https://corpgov.law.harvard.edu/2020/07/21/comment-letter-on-proposed-regulation-of-esg-standards-in-erisa-plans/ ("For example, as of July 5, 2020, [the] ACWI exchange traded fund, which tracks the ACWI equity index, had a net expense ratio of 32 basis points. The CRBN exchange traded fund, which also tracks the ACWI equity index but with a lower carbon footprint, had a net expense ratio of 20 basis points. Both are part of Blackrock's iShares family of ETFs.").

67. Financial Factors in Selecting Plan Investments, 85 Fed. Reg. at 72847.

68. *See id.* at 72851.

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B. History of Social Investing

Investors have engaged in social investing—investing that considers non-financial benefits in addition to financial benefits—for many years.[69] An early example in the United States involved anti-slavery efforts by the Quaker Philadelphia Yearly Meeting, which in 1758 prohibited members from buying or selling humans.[70] In the 1980s, social investing received renewed attention in connection with the movement to divest from companies doing business in South Africa, a divestment movement that sought the abolition of South African apartheid.[71] Over time, social investing became known as socially responsible investing ("SRI"), and many early forms of SRI used negative screens to remove categories of stocks from a portfolio.[72] For example, sin stocks—tobacco, firearms, gambling, and alcohol—were, and still are, common screens.[73]

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69. For an excellent explanation of the development of socially responsible investing and the terminology used, see LAUREN CAPLAN ET AL., COMMONFUND INST., FROM SRI TO ESG: THE CHANGING WORLD OF RESPONSIBLE INVESTING (Sept. 2013), and Susan N. Gary, *Best Interests in the Long Term: Fiduciary Duties and ESG Integration*, 90 U. COLO. L. REV. 731, 736–47 (2019) (describing the history of socially responsible investing terminology) [hereinafter Gary, *Best Interests in the Long Term*].

70. *What Is Socially Responsible Investing? Definition and Meaning*, MKT. BUS. NEWS, https://marketbusinessnews.com/financial-glossary/socially-responsible-investing/ (last visited June 22, 2022); Albert Feuer, *Ethics, ESG, and ERISA: Ethical-Factor Investing of Savings and Retirement Benefits*, 47 TAX MGMT. COMP. PLAN. J. 212, 216 (2019); Benjamin J. Richardson, *Putting Ethics into Environmental Law: Fiduciary Duties for Ethical Investment*, 46 OSGOODE HALL L.J. 243, 245 (2008).

71. *See* Joel C. Dobris, *Arguments in Favor of Fiduciary Divestment of "South African" Securities*, 65 NEB. L. REV. 209 (1986); John H. Langbein & Richard A. Posner, *Social Investing and the Law of Trusts*, 79 MICH. L. REV. 72, 72–73 (1980).

72. *See* Gary, *Best Interests in the Long Term*, *supra* note 69, at 737–40 (describing the use of negative screens); SOC. INV. F., AFTER SOUTH AFRICA: THE STATE OF SOCIALLY RESPONSIBLE INVESTING IN THE UNITED STATES (1995), https://perma.cc/95K3-CVNP (describing issues addressed in early negative and positive screens) [hereinafter THE STATE OF SOCIALLY RESPONSIBLE INVESTING IN THE U.S.].

73. Lloyd Kurtz & Dan diBartolomeo, *The Long-Term Performance of a Social Investment Universe*, J. INVESTING, Fall 2011, at 95, 96 (describing the methodology of the KLD 400 and explaining that the KLD 400 excludes "[c]ompanies involved beyond specific thresholds in alcohol, tobacco, firearms, gambling, nuclear power and military weapons"). The 1995 Trends Report from the Social Investment Forum found that of managers using screens, 86% avoided tobacco stocks, 73% avoided alcohol stocks, and 64% avoided weapons stocks. *See* THE STATE OF SOCIALLY RESPONSIBLE INVESTING IN THE U.S., *supra* note 72, at 5.

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In the decades following the 1980s, different types of SRI strategies developed as investors turned to best-in-class positive strategies focusing on which companies or sectors to include rather than on which companies or sectors to exclude.[74] More recently, investors developed tools for using ESG information about companies in making investment decisions.[75] Although this Article sometimes uses the term ESG investing as a catch-all for strategies that incorporate ESG information, no one ESG strategy or type of ESG fund exists.

One strategy, which may be referred to as ESG integration, integrates financially material ESG factors with more traditional financial metrics to improve investment choices.[76] As financial analysts realized that some ESG information was material, they began to incorporate the information into their analyses.[77] ESG factors include information about such things as product safety, workforce turnover, workplace protections for employees, exposure to physical climate change risks, hazardous waste disposal

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74. A best-in-class process looks for the "best" companies in an industry or sector, from the standpoint of environmental or social factors. Rather than excluding a sector, a best-in-class selection process could include a sector that did not have the highest sustainability ratings and select the companies within that sector that were doing the best in terms of improving their environmental impact or providing good labor conditions for employees. *See* RCM SUSTAINABILITY WHITE PAPER: SUSTAINABILITY: OPPORTUNITY OR OPPORTUNITY COST? 2 (RCM Ltd., July 2011), https://www.msci.com/documents/10199/248121/11_10717_RCMSWP_ET1907.pdf [https://perma.cc/B27R-8W5X] (describing the creation of a best-in-class portfolio).

75. RCM uses the term "sustainability investing," and its definition matches the general understanding of ESG investing: "Sustainability investing is broader than an ethically or socially responsible investment strategy. Material environmental, social and governance factors are considered alongside financial factors, identifying risks and opportunities that have not been fully priced in by the markets thus supporting enhanced stock selection and providing RCM with an information advantage." *Id.* at 14; *see also* CAPLAN ET AL., *supra* note 69 (explaining that, in contrast with early SRI, "ESG analysis takes a broader view, examining whether environmental, social and governance issues may be material to a company's performance, and therefore to the investment performance of a long-term portfolio"); ASSET MGMT. WORKING GRP., UNEP FIN. INITIATIVE & MERCER, DEMYSTIFYING RESPONSIBLE INVESTMENT PERFORMANCE: A REVIEW OF KEY ACADEMIC AND BROKER RESEARCH ON ESG FACTORS 60 (2007), http://www.unepfi.org/fileadmin/documents/DemystifyingResponsibleInvestmentPerformance01.pdf [https://perma.cc/Y24H-44KW] (defining corporate social responsibility).

76. *See* Gary, *Best Interests in the Long Term*, *supra* note 69, at 745–47 (describing ESG integration).

77. Mozaffar Khan et al., *Corporate Sustainability: First Evidence on Materiality*, 91 ACCT. REV. 1697, 1697 n.1 (2016).

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practices, and board member engagement and skills.[78] A company's behavior with respect to any of these factors may be financially material, but the information may not be included in financial statements. By expanding beyond traditional financial analysis, ESG integration provided analysts with more information about opportunities and risks.[79] As analysts and investors began to realize the financial impacts of such information, ESG investing ideas moved into the mainstream.[80] Some investors use ESG information for both financial and non-financial purposes, and some investors use ESG investing solely for financial reasons.[81]

C. Cost to the Portfolio

The idea that ESG investing is one more form of SRI has led to persistent assumptions that the use of ESG factors will result in a cost to the portfolio.[82] The explanations for these assumptions lie in the history of SRI, outlined above. Negative screens were seen as reducing diversification, an important component of modern portfolio theory.[83] Although fund managers adjusted the portfolios to compensate for sectors that were removed,[84] the idea that any negative screen would result in a cost to the portfolio persisted.[85] Dylan Minor created a study of SRI and non-SRI

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78. *See* Gary, *Best Interests in the Long Term*, *supra* note 69, at 746; *Final ERISA Rules Circle Back to Allow ESG Investing*, *supra* note 6.

79. *See generally* ROBERT G. ECCLES & MIRTHA D. KASTRAPELI, THE INVESTING ENLIGHTENMENT: HOW PRINCIPLE AND PRAGMATISM CAN CREATE SUSTAINABLE VALUE THROUGH ESG 8 (2017), http://www.statestreet.com/content/dam/statestreet/documents/Articles/The_Investing_Enlightenment.pdf [https://perma.cc/GB53-ZM8H] (addressing the misconception that ESG integration requires financial returns to be sacrificed).

80. *See US SIF, Investor Organizations and Financial Industry Firms' Analysis of Public Comments*, *supra* note 6.

81. *See* ECCLES & KASTRAPELI, *supra* note 79, at 12.

82. *See, e.g.*, Jon Hale, *Does Sustainable Investing Help or Hurt Returns?*, MORNINGSTAR (Dec. 7, 2017), http://news.morningstar.com/articlenet/article.aspx?id=839607 [https://perma.cc/F5JL-RRMH] (describing the continuing "misimpression" that sustainable investing will hurt returns).

83. *See* Gary, *Best Interests in the Long Term*, *supra* note 69, at 748–50; Langbein, *supra* note 35, at 646–50.

84. *See* Adam M. Kanzer, *Exposing False Claims About Socially Responsible Investing: A Response to Adler and Kritzman*, ADVISOR PERSPS. (June 4, 2013), https://www.advisorperspectives.com/articles/2013/06/04/exposing-false-claims-about-socially-responsible-investing-a-response-to-adler-and-kritzman [https://perma.cc/6JTX-TQDU].

85. Mark Kritzman and Timothy Adler used a Monte Carlo simulation to show that if a manager randomly removed a percentage of stocks from a portfolio, the portfolio would suffer a financial cost. *Id.* They then argued that an SRI fund using a screen related to fossil

funds to prove the hypothesis that "while there may be no net *total* cost (i.e., financial *and* social costs and benefits) with SRI, according to fundamental economic principles, there must be a net *financial* cost to SRI."[86] To his surprise, Minor found no statistically significant difference between the funds.[87]

A second concern about any SRI strategy is that the administrative costs of identifying companies to include or exclude will be excessive. The DOL expressed this concern in the purpose statement of the 2020 Rule, stating that "ESG funds often come with higher fees, because additional investigation and monitoring are necessary to assess an investment from an ESG perspective."[88] While it is true that there is a difference in fees between actively managed funds and passive funds, that difference is not specific to funds that integrate ESG factors. As Langbein and Posner noted in 1980, any managed fund will have fees that exceed the administrative expenses in passive funds.[89] After expressing skepticism "that a portfolio constructed in accordance with consistent, and consistently applied, social principles could avoid serious underdiversification,"[90] they concluded "that a social-investing portfolio will probably have the same expected return as a standard investment portfolio (of the same systematic risk),"[91] but with higher administrative costs as compared to a passive fund.[92] They added that a social investing fund "need not generate higher administrative costs

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fuels would bear that cost. Timothy Adler & Mark Kritzman, *The Cost of Socially Responsible Investing*, 35 J. PORTFOLIO MGMT. 52 (2008). *See generally* DANIEL R. FISCHEL, FOSSIL FUEL DIVESTMENT: A COSTLY AND INEFFECTIVE INVESTMENT STRATEGY 6–11 (2017), http://divestmentfacts.com/pdf/Fischel_Report.pdf [https://perma.cc/966W-ZZ3R] (finding, after a study commissioned and financed by the Independent Petroleum Association of America, a potential diversification cost for fossil fuel divestment by focusing on divestment from the "energy sector" as a whole); Langbein & Posner, *supra* note 71, at 85 ("[S]tocks are added to and subtracted from the portfolio by the social investor without regard to the effect on diversification.").

86. *See* Dylan B. Minor, *Finding the [Financial] Cost of Socially Responsible Investing*, J. INVESTING, Fall 2007, at 54.

87. *Id.* at 66.

88. Financial Factors in Selecting Plan Investments, 85 Fed. Reg. 72846, 72848 (Nov. 13, 2020) (to be codified at 29 C.F.R. pts. 2509, 2550).

89. *See* Langbein & Posner, *supra* note 71, at 82–83.

90. *Id.* at 88.

91. *Id.* at 93.

92. *Id.*

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than an investment strategy that involves research and active trading."[93] An empirical study published in 2021 by Quinn Curtis, Jill Fisch, and Adriana Robertson addressed the question of costs, as well as other concerns about ESG investing.[94] The professors identified and analyzed "ESG funds"[95] and concluded that "ESG funds do not appear to be charging investors higher fees or sacrificing returns relative to their traditional counterparts."[96]

D. ESG Integration and the Prudent Investor Standard

A prudent investor reviews current information about investment strategies and considers information being used by financial analysts and other investors.[97] Studies that compare actively managed funds using a variety of SRI strategies with actively managed funds that do not indicate the use of any form of SRI have shown predominantly neutral or better results, especially for funds using ESG integration.[98] The studies are

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93. *Id.* Langbein and Posner's concerns over a fiduciary's use of what they called social investing was tied to their view that fiduciaries should invest in passive rather than actively managed funds. In 1988, funds engaged in social investing were necessarily actively managed; passive ESG funds have developed more recently. Langbein and Posner describe social investing as involving active engagement in securities analysis because the analysts must consider the ESG information. *Id.* In 2022, ESG mutual funds, index funds, and exchange-traded funds ("ETFs") are available. Rob Berger, *The Best ESG Funds of June 2022*, FORBES ADVISOR (June 1, 2022, 1:17 AM), https://www.forbes.com/advisor/investing/best-esg-funds/.

94. *See* Curtis, Fisch & Robertson, *supra* note 2.

95. *Id.* at 395. The authors identified ESG funds in two ways: (i) by screening fund names for keywords like "esg," "impact," and "responsible" and then hand checking the funds to confirm an ESG connotation; and (ii) by using the Morningstar list of ESG funds. *Id.* at 419, 419 n.140. Their analysis then examined the extent to which the identified ESG funds invest in companies with higher ESG ratings, the voting patterns of ESG and non-ESG funds, and the pecuniary costs and pecuniary performances of ESG and non-ESG funds. *Id.* at 423–42.

96. *Id.* at 450.

97. *See generally* RESTATEMENT (THIRD) OF TRUSTS §§ 90–92 (AM. LAW INST. 2007). For the history of the prudent investor rule, see GARY ET AL., *supra* note 30, § 613, and Langbein, *supra* note 35, at 643–45 (describing the history and development of the prudence standard prior to the Uniform Prudent Investor Act).

98. *See, e.g.*, Curtis, Fisch & Robertson, *supra* note 2; TENSIE WHELAN ET AL., ROCKEFELLER ASSET MGMT. & NYU STERN CTR. FOR SUSTAINABLE BUS., ESG AND FINANCIAL PERFORMANCE: UNCOVERING THE RELATIONSHIP BY AGGREGATING EVIDENCE FROM 1,000 PLUS STUDIES PUBLISHED BETWEEN 2015 – 2020 (2020), https://www.stern.nyu.edu/sites/default/files/assets/documents/NYU-RAM_ESG-Paper_2021%20Rev_0.pdf. For descriptions of studies analyzing funds using different types of SRI strategies, see Gary,

important for a prudent investor to consider, both because they counter the myths of a "necessary cost" with ESG investing when actively managed funds are compared with other actively managed funds, and because they suggest that investors may obtain financial benefits or reduced risk by using ESG integration.[99] As more passive investments using ESG factors are developed, passive investments are also available.[100]

As an example of the increasing use of ESG information, the CFA Institute reported that in 2020, 85% of CFA Institute members reported taking E, S, or G factors into consideration, an increase from 73% in 2017.[101] Studies have shown that funds using ESG integration achieved improved returns on a risk-adjusted basis, especially when analyzed over a longer time period.[102] One of the comment letters submitted to the DOL describes some of the results:

> One meta review of approximately 2200 studies of corporate performance found that 63% of them associated better ESG performance with higher value creation (only 8% had negative findings). Other studies suggest that high performing ESG companies create value disproportionate to their peers: "ESG links to cash flow in five important ways: (1) facilitating top-line growth, (2) reducing costs, (3) minimizing regulatory and legal interventions, (4) increasing employee productivity, and (5) optimizing investment and capital expenditures," according to a study published in the November 2019 McKinsey Quarterly.[103]

Values and Value, *supra* note 39, at 281–90, and Gary, *Best Interests in the Long Term*, *supra* note 69, at 747–66.

99. The Curtis et al. study is important in this regard given the comprehensiveness of the study. *See* Curtis, Fisch & Robertson, *supra* note 2.

100. *See id.* at 395 ("Morningstar reports that both the number of ESG-focused index funds and the total amount of assets held by such funds have doubled in the past three years.").

101. CFA INST., FUTURE OF SUSTAINABILITY IN INVESTMENT MANAGEMENT: FROM IDEAS TO REALITY 13 (2020), https://www.cfainstitute.org/-/media/documents/survey/future-of-sustainability.ashx.

102. *See* Lukomnik, *supra* note 66 (discussing the results of a study published in the November 2019 *McKinsey Quarterly*).

103. *Id.* The letter was informed by and signed by thirty people with "experience and expertise relating to retirement savings." *Id.* The letter lists academic affiliations, numbers of books and articles published, and key administrative or consulting positions held by the signers. *Id.*

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After noting in this comment letter that ESG-based investing has outperformed benchmarks, economist Lukomnik explains his worry that the 2020 Proposed Rule would endanger retirement security.[104]

A 2020 meta-study examined more than one thousand research papers from 2015 to 2020, dividing the articles between those focused on corporate financial performance and those focused on investment performance.[105] For the corporate studies, the authors reported the relationship between ESG and financial performance to be positive for 58%, neutral for 13%, mixed for 21%, and negative for 8%.[106] For the investment studies, 59% showed performance similar to or better than conventional investment approaches, and 14% showed negative results.[107] The authors concluded that "[i]mproved financial performance due to ESG becomes more marked over longer time horizons" and that "ESG integration, broadly speaking as an investment strategy, seems to perform better than negative screening approaches."[108]

One challenge in using ESG information is that the reporting by companies has not been consistent or thorough. The Global Reporting Initiative ("GRI"), created in 1997, issued a global sustainability reporting framework in 2000 and has continued to update the guidelines.[109] The Sustainability Accounting Standards Board ("SASB") developed a set of seventy-seven industry-specific standards and published the final version in 2018.[110] The standards focus on financial materiality, with the goal of making the information more accessible to investors.[111] In June 2021, the SASB merged with the International Integrated Reporting Council ("IIRC")[112] to become the Value Reporting Foundation.[113] The Value

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104. *Id.*

105. WHELAN ET AL., *supra* note 98, at 2.

106. *Id.*

107. *Id.*

108. *Id*. at 3.

109. *See* Gary, *Best Interests in the Long Term*, *supra* note 69, at 773–74, 733 n.192 (describing the history of GRI and development of the GRI Standards).

110. *Id.* at 772–73.

111. *Id.*

112. The IIRC developed an integrated reporting framework organized around six types of capital: financial, manufacture, intellectual, human, social and relationship, and natural. *Id.* at 775.

113. *IIRC and SASB Form the Value Reporting Foundation, Providing Comprehensive Suite of Tools to Assess, Manage and Communicate Value*, GLOBENEWSWIRE (June 9, 2021, 9:30 AM ET), https://www.globenewswire.com/en/news-release/2021/06/09/2244505/0/en/

Reporting Foundation combines the SASB standards with the Integrated Reporting Framework developed by the IIRC, with the goal of providing "a more complete picture of long-term value creation while meeting investor needs for comparable, consistent, and reliable information."[114]

The SEC requires reporting of any financially material information[115] and is working on improving disclosures related to ESG investing.[116] SEC Chair Gary Gensler has said that "in his view not only do investors want this information, but also that issuers would benefit from 'such guidance.'"[117] In addition to providing material information, a concern is that disclosure be accurate.[118] Terms like "green" and "sustainable" do not have standardized meanings, and Gensler asked SEC staff to consider whether to require disclosures that would provide information about the criteria and data used to create a fund.[119]

IIRC-and-SASB-form-the-Value-Reporting-Foundation-providing-comprehensive-suite-of-tools-to-assess-manage-and-communicate-value.html.

114. VALUE REPORTING FOUND., https://www.valuereportingfoundation.org/ (last visited June 1, 2022).

115. *See generally* SEC Staff Accounting Bulletin No. 99, 17 C.F.R. pt. 211 (Aug. 12, 1999).

116. *See* Andrew Ramonas, *SEC's Gensler Eyes ESG Reporting Rules After Public Input*, BLOOMBERG L. (May 6, 2021, 3:23 PM), https://news.bloomberglaw.com/securities-law/secs-gensler-eyes-esg-reporting-rules-after-public-input; Press Release, U.S. Sec. & Exch. Comm'n, SEC Proposes to Enhance Disclosures by Certain Investment Advisers and Investment Companies About ESG Investment Practices (May 25, 2022), https://www.sec.gov/news/press-release/2022-92 [hereinafter Press Release, SEC Proposes to Enhance Disclosures]. In March 2021, the SEC announced the creation of a Climate and ESG Task Force in the Division of Enforcement "to identify any material gaps or misstatements in issuers' disclosure of climate risks under existing rules." Press Release, U.S. Sec. & Exch. Comm'n, SEC Announces Enforcement Task Force Focused on Climate and ESG Issues (Mar. 4, 2021), https://www.sec.gov/news/press-release/2021-42.

117. Betty Moy Huber et al., *Gensler and SEC's 2021 Examination Priorities Highlight ESG and Climate Risk*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Mar. 20, 2021), https://corpgov.law.harvard.edu/2021/03/20/gensler-and-secs-2021-examination-priorities-highlight-esg-and-climate-risk/.

118. *See* Curtis, Fisch & Robertson, *supra* note 2 (reporting the results of their extensive empirical examination of ESG mutual funds). The Curtis et al. study found that "contrary to the SEC's concern about 'greenwashing,' ESG funds deliver on their promise to invest differently from other funds, and their holdings are rated more highly with respect to ESG." *Id.* at 399. The study also examined proxy voting and found "clear differences between the voting behavior of ESG and non-ESG funds." *Id.*

119. Gary Gensler, *Chair Gensler's Remarks at the Asset Management Advisory Committee Meeting*, HARV. L. SCH. F. ON CORP. GOVERNANCE (July 11, 2021), https://corpgov.law.harvard.edu/2021/07/11/chair-genslers-remarks-at-the-asset-management-advisory-

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In May 2022, the SEC issued proposed amendments to rules and disclosure forms to improve reporting by investment companies and advisors that use ESG strategies.[120] The proposal requires specific disclosures in fund prospectuses, annual reports, and advisor brochures.[121] The proposal creates categories of ESG strategies and then applies different requirements to each category.[122] Funds that integrate ESG factors with other factors would be required to describe how they incorporate ESG factors into the investment process.[123] ESG-focused funds would be required to provide details about how they use the ESG factors and to provide a standardized ESG strategy overview table, making comparisons with other funds easier.[124] Funds that seek a particular ESG impact would be required to disclose how the fund measures progress.[125] Funds that use proxy voting in connection with ESG goals would need to provide information about their proxy voting strategy or other engagement with issuers.[126] Finally, any ESG-focused fund that considers environmental factors would need to disclose the greenhouse gas emissions associated with the investments, as a way of providing the carbon footprint and weighted average carbon intensity of their portfolio.[127]

The SEC will consider public comments before issuing final amendments, but some amendments to the disclosure requirements seem likely. With increased attention to disclosure of ESG information, investors will have better information and fiduciaries will need to pay more attention to the disclosures.

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committee-meeting/ ("I think updates to fund disclosures and to naming conventions could bring needed transparency to the asset management industry, particularly in light of the significant growth in the sustainability area. This gets to the heart of the SEC's mission to protect investors and efficiently allocate capital.").

120. Press Release, SEC Proposes to Enhance Disclosures, *supra* note 116. The SEC had earlier issued a proposed rule on climate-related disclosure. The Enhancement and Standardization of Climate-Related Disclosures for Investors, 87 Fed. Reg. 21334 (Apr. 11, 2022) (to be codified at 17 C.F.R. pts. 210, 229, 232, 239, 249).

121. Enhanced Disclosures by Certain Investment Advisers and Investment Companies About Environmental, Social, and Governance Investment Practices, 87 Fed. Reg. 36654 (June 17, 2022) (to be codified at 17 C.F.R. pts. 200, 230, 232, 239, 249, 274, 279).

122. *Id.* at 36657. The proposal names the strategies ESG Integration, ESG-Focused, and ESG Impact. *Id.*

123. *Id.* at 36660–62.

124. *Id.* at 36662–68.

125. *Id*. at 36668–69.

126. *Id*. at 36669–71.

127. *Id.* at 36676–85.

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IV. DOL Guidance Regarding the Use of ESG Factors

The DOL provides guidance to pension fiduciaries governed by ERISA, including guidance focused on fiduciary investing. A quick review of guidance issued in 1994, 2008, and 2015 reveals two things: the guidance shifts slightly depending on the administration in power, and the underlying fiduciary duties remain unchanged.[128] With the changes in guidance, pension managers are left trying to figure out what types of investment strategies are acceptable and without risk to the fiduciaries. A knee-jerk reaction might be to avoid anything with a whiff of "social investing,"[129] but given that material ESG factors can identify financial risks, simply avoiding any strategies that use ESG factors is increasingly problematic.[130] Further, it appears that many analysts use material ESG factors without identifying their managed funds as "ESG funds" by name or otherwise.[131] Avoidance of funds that use ESG factors in analysis may require a great deal of investigation and associated costs. A prudent investor should consider material financial factors, and some ESG factors fall within that category.[132] The question for managers is what they may consider and what

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128. *See generally* Interpretive Bulletin Relating to the Employee Retirement Income Security Act of 1974, 59 Fed. Reg. 32606 (June 23, 1994) (codified at 29 C.F.R. § 2509.94-1) (I.B. 94-1); Interpretive Bulletin Relating to Investing in Economically Targeted Investments, 73 Fed. Reg. 61734 (Oct. 17, 2008) (codified at 29 C.F.R. § 2509.08-01) (I.B. 2008-01) (superseding I.B. 94-1); Interpretive Bulletin Relating to the Fiduciary Standard Under ERISA in Considering Economically Targeted Investments, 80 Fed. Reg. 65135 (Oct. 26, 2015) (codified at 29 C.F.R. § 2509.2015-01) (I.B. 2015-1) (replacing I.B. 2008-01 to reinstate the language of I.B. 94-1).

129. Curtis, Fisch & Robertson, *supra* note 2, at 418 ("[P]lan sponsors might be sufficiently risk averse, particularly in light of the threat of private litigation, to avoid funds that foreground ESG goals.").

130. *See Final ERISA Rules Circle Back to Allow ESG Investing*, *supra* note 6 ("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.").

131. *See* Robert G. Eccles et al., *Market Interest in Nonfinancial Information*, J. APPLIED CORP. FIN., Fall 2011, at 113, 120–24 (finding a high level of market interest in ESG disclosure, based on an analysis of "hits" accessing nonfinancial metrics in the Bloomberg database).

132. *See* Lukomnik, *supra* note 66 ("[A]cademicians believe ESG is economically material, regulators in other jurisdictions believe ESG to be economically material, and some $40 trillion already is managed with ESG considerations, which is a material subset of the entire global capital market.").

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they should consider. This section reviews earlier guidance and then examines the 2020 Rule and the 2021 Proposed Rule.

A. IB 94-1

In 1994, the DOL issued Interpretive Bulletin 94-1 to clarify that investments that were selected for collateral (e.g., social or environmental) benefits, as well as financial return, were acceptable, so long as the financial returns on a risk-adjusted basis were comparable to the expected risk-adjusted returns of other investments available to the pension plan.[133] IB 94-1 focused on economically targeted investments ("ETIs"), investments "designed to produce competitive . . . return[s]" while creating "collateral economic benefits."[134] The guidance stated that plan assets could not be used to promote public policy interests at the expense of the financial interests of the plan's beneficiaries and that fiduciaries should not accept lower expected financial returns in order to accomplish or consider non-financial goals.[135]

B. IB 2008-01

In 2008, the DOL replaced IB 94-1 with Interpretive Bulletin 2008-01.[136] The new guidance said that it did not alter the basic legal principles of IB 94-1,[137] but it apparently intended to discourage socially responsible investing. IB 2008-01 stated that consideration of collateral, non-economic factors in investment decision-making should be rare and well documented.[138] IB 94-1 and IB 2008-01 refer respectively to "collateral"[139] and "non-economic"[140] factors and reflect the view that any non-traditional

133. *See* Interpretive Bulletin Relating to the Employee Retirement Income Security Act of 1974, 59 Fed. Reg. at 32606. The 2015 Bulletin explains that IB 94-1 was issued "to correct a popular misperception at the time that investments in ETIs are incompatible with ERISA's fiduciary obligations." Interpretive Bulletin Relating to the Fiduciary Standard Under ERISA in Considering Economically Targeted Investments, 80 Fed. Reg. at 65135.

134. *See* Lurie, *supra* note 50, at 316.

135. Interpretive Bulletin Relating to the Employee Retirement Income Security Act of 1974, 59 Fed. Reg. at 32606–07.

136. Interpretive Bulletin Relating to Investing in Economically Targeted Investments, 73 Fed. Reg. 61734, 61734 (Oct. 17, 2008) (codified at 29 C.F.R. § 2509.08-01).

137. *See id.*

138. *Id.*

139. Interpretive Bulletin Relating to the Employee Retirement Income Security Act of 1974, 59 Fed. Reg. at 32606.

140. Interpretive Bulletin Relating to Investing in Economically Targeted Investments, 73 Fed. Reg. at 61734.

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factors do not have economic significance. IB 2008-01 resulted in confusion about how to treat ESG factors that have current or long-term financial or risk implications.[141]

C. IB 2015-01

As awareness of the financial materiality of ESG factors grew, the DOL issued Interpretive Bulletin 2015-01.[142] This bulletin, which addresses both ETIs and ESG investing, removes IB 2008-01, reinstates IB 94-1, and provides additional guidance.[143] IB 2015-01 explains that the DOL had become concerned "that the 2008 guidance may be dissuading fiduciaries from (1) pursuing investment strategies that consider environmental, social, and governance factors, even where they are used solely to evaluate the economic benefits of investments and identify economically superior investments, and (2) investing in ETIs even where economically equivalent."[144]

Fiduciaries should consider factors that may affect the risk and return of investments, and IB 2015-01 reflects the DOL's recognition that "[e]nvironmental, social, and governance issues may have a direct relationship to the economic value of the plan's investment."[145] The guidance explains that "[i]n these instances, such issues are not merely collateral considerations or tie-breakers, but rather are proper components of the fiduciary's primary analysis of the economic merits of competing investment choices."[146] IB 2015-01 clarifies that ERISA fiduciaries may consider the collateral benefits of ETIs "so long as the investment is economically equivalent, with respect to return and risk to beneficiaries in the appropriate time horizon, to investments without such collateral benefits."[147] The guidance aligns with the duty of loyalty, even if the duty to act in the beneficiaries' best interests is limited to financial interests. If the beneficiaries' financial interests are not adversely affected, other interests—collateral benefits—may be considered.

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141. Interpretive Bulletin Relating to the Fiduciary Standard Under ERISA in Considering Economically Targeted Investments, 80 Fed. Reg. 65135, 65136 (Oct. 26, 2015) (codified at 29 C.F.R. § 2509.2015-01).

142. *Id.* at 65135.

143. *Id.*

144. *Id.* at 65136.

145. *Id.*

146. *Id.*

147. *Id.*

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D. 2018 Field Assistance Bulletin

In 2018, the DOL issued a Field Assistance Bulletin providing additional guidance.[148] Referring to the 2015 Bulletin, the guidance says that "the Department merely recognized that there could be instances when otherwise collateral ESG issues present material business risk or opportunities to companies that company officers and directors need to manage."[149] The 2018 Bulletin then explains that "[i]n such situations, these ordinarily collateral issues are themselves appropriate economic considerations, and thus should be considered by a prudent fiduciary along with other relevant economic factors."[150] The 2018 guidance exemplifies the back-and-forth as presidential administrations change. The 2015 Bulletin, issued during the Obama administration, reminds fiduciaries that ESG factors may be financially material but adds that collateral benefits may be considered as long as the investment does not generate lower returns or higher risk.[151] The 2018 Bulletin, issued during the Trump administration, also indicates that ESG factors may be relevant economic factors to consider, but this Bulletin limits the guidance to the factors' economic relevance and ignores any collateral benefits.[152] The overall guidance is similar: a prudent fiduciary should consider financially material ESG factors as appropriate for the purposes of the plan.

E. 2020 Rule: Financial Factors in Selecting Plan Investments

The DOL issued a Proposed Rule in June 2020.[153] Although the DOL presented the proposal as necessary to protect the financial interests of pension plan participants,[154] the rationale behind the proposal may have

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148. Emp. Benefits Sec. Admin., U.S. Dep't of Labor, Field Assistance Bull. No. 2018-01, Interpretive Bulletins 2016-01 and 2015-01 (Apr. 23, 2018), https://www.dol.gov/sites/dolgov/files/ebsa/employers-and-advisers/guidance/field-assistance-bulletins/2018-01.pdf.

149. *Id.*

150. *Id.*

151. *See id.*

152. *See id.*

153. Financial Factors in Selecting Plan Investments, 85 Fed. Reg. 39113 (proposed June 30, 2020).

154. News Release, Emp. Benefits Sec. Admin., U.S. Dep't of Labor, U.S. Department of Labor Proposes New Investment Duties Rule (June 23, 2020), https://www.dol.gov/newsroom/releases/ebsa/ebsa20200623 (quoting Acting Assistant Secretary of Labor for the Employee Benefits Security Administration Jeanne Klinefelter Wilson) ("Providing further clarity on fiduciaries' responsibilities in ESG investing will help safeguard the interests of participants and beneficiaries."); Financial Factors in Selecting Plan Investments, 85 Fed.

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been an attempt to shore up the energy sector.[155] The proposal was issued in response to an executive order on "Promoting Energy Infrastructure and Economic Growth," which called on the DOL to review information on ERISA plans to "identify whether there are discernable trends with respect to such plans' investments in the energy sector."[156] Notably, the North American Coal Corporation submitted one of the few letters supporting the proposed regulations, and in that letter the corporation complained that "the coal sector is being targeted by environmental, social, and corporate governance ('ESG') activists."[157]

The Proposed Rule took direct aim at the growing use of ESG investing.[158] In explaining the purpose of the Proposed Rule, the DOL stated 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."[159] As the public comments submitted in response to the Proposed Rule pointed out, however, this statement reflects "a flawed and unsupported assumption that ESG funds

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Reg. at 39121 ("The proposed rule would replace existing guidance on the use of ESG and similar factors in the selection of investments, including that fiduciaries must not base investment decisions on non-pecuniary factors unless alternative investment options are 'economically indistinguishable' and such a conclusion is properly documented."). The Proposed Rule does not require that choices of other types of investment strategies (e.g., growth, value, passive, active) be "economically indistinguishable" and "properly documented." *See id.*

155. *See* Letter from Patty Murray et al., U.S. Sens., to Eugene Scalia, Sec'y, U.S. Dep't of Lab., on Financial Factors in Selecting Plan Investments (RIN 1210-AB95) (July 30, 2020), https://www.help.senate.gov/imo/media/doc/073020%20FINAL%20ESG%20Comment%20Letter1.pdf.

156. *Id.* at 4.

157. Letter from Rebecca McGrew, Manager of Regul. & Env't Affs., N. Am. Coal Corp., to Off. of Regul. & Interpretations, U.S. Dep't of Lab., on Comments of the North American Coal Corporation (RIN 1210-AB95) (July 30, 2020), https://www.dol.gov/sites/dolgov/files/EBSA/laws-and-regulations/rules-and-regulations/public-comments/1210-AB95/00608.pdf.

158. Describing the need for the new regulation, the DOL says, "Recently, there has been an increased emphasis in the marketplace on investments and investment courses of action that further non-pecuniary objectives, particularly what have been termed environmental, social, and corporate governance (ESG) investing." Financial Factors in Selecting Plan Investments, 85 Fed. Reg. at 39120.

159. *Id.* at 39116.

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give up financial returns in favor of 'non-pecuniary' rewards."[160] The DOL stated its intent "to provide clarity and certainty regarding the scope of fiduciary duties,"[161] but the proposal appeared to be an attempt to chill the use of any ESG investing by requiring extensive comparative research and documentation.[162]

The DOL received what may be a record number of comments for an ERISA fiduciary regulation, with 1,100 individual comment letters and 7,617 names associated with six petitions.[163] Ninety-five percent of the comments opposed the proposed regulation.[164] The Reinhart law firm summarized the comments objecting to the proposal:

- 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

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160. *US SIF, Investor Organizations and Financial Industry Firms' Analysis of Public Comments*, *supra* note 6.

161. Financial Factors in Selecting Plan Investments, 85 Fed. Reg. at 39116.

162. *US SIF Releases Statement on Department of Labor Rulemaking Related to ERISA and ESG Considerations*, US SIF (June 24, 2020, 4:43 PM), https://www.ussif.org/blog_home.asp?display=141 (quoting Lisa Woll, CEO, US SIF) ("The proposal would put a substantial additional burden on fiduciaries who wish to utilize ESG investments by requiring additional investment analysis and documentation requirements . . . .") ("Generating more hurdles to the incorporation of ESG criteria will have a chilling effect . . . .") [hereinafter *US SIF Releases Statement*].

163. BRADFORD CAMPBELL, NATIXIS INV. MANAGERS, DOL PAVES THE WAY FOR ERISA PLAN ESG INVESTMENTS IN FINAL "PECUNIARY FACTOR" RULE 1 n.1 (2020), https://www.intentionalendowments.org/investments_in_final_pecuniary_factor_rule; *see also US SIF, Investor Organizations and Financial Industry Firms' Analysis of Public Comments*, *supra* note 6. The DOL noted that "[m]any commenters requested an extension of the comment period" but that it determined that the record created was "sufficient." Financial Factors in Selecting Plan Investments, 85 Fed. Reg. 72846, 72850 (Nov. 13, 2020) (to be codified at 29 C.F.R. pts. 2509, 2550).

164. *Final ERISA Rules Circle Back to Allow ESG Investing*, *supra* note 6; *see also US SIF, Investor Organizations and Financial Industry Firms' Analysis of Public Comments*, *supra* note 6. The US SIF analysis found that 96% of comments from individuals (8,337 total), 94% of investment-related groups (229 total), and 57% of non-investment-related firms and organizations (120 total) expressed opposition to the Proposed Rule. *Id.* Of the remaining comments, a significant number were mixed or neutral, so the actual number of comments in support of the Proposed Rule was quite low. *See id.*

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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.[165]

In general, the comments pointed out that imposing administrative burdens on investment strategies that incorporate ESG factors could result in higher risk exposures and lower returns, the opposite of what the DOL claimed to be doing.[166] Further, the proposal focused on a single investment category rather than on the financial materiality of all investment products.[167] As Lisa Woll, CEO of US SIF, explained, "[T]he DOL proposal is out of step with professional investment managers, who increasingly analyze ESG factors precisely because of risk, return and fiduciary considerations."[168]

When the DOL issued the final rule on November 13, 2020, many of the documentation aspects of the proposal had been removed.[169] The 2020 Rule emphasizes the long-standing guidance 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

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165. *Final ERISA Rules Circle Back to Allow ESG Investing*, *supra* note 6.

166. In response to the Proposed Rule, Ceres CEO and President Mindy Lubber said, "As the comment letters confirm, ESG risks are often systemic risks that pose short, medium and long term financial risks to investment portfolios." *US SIF, Investor Organizations and Financial Industry Firms' Analysis of Public Comments*, *supra* note 6.

167. *See supra* note 154.

168. *US SIF Releases Statement*, *supra* note 162.

169. *See* Financial Factors in Selecting Plan Investments, 85 Fed. Reg. 72846 (Nov. 13, 2020) (to be codified at 29 C.F.R. pts. 2509, 2550).

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plan's funding policy and investment policy objectives."[170] The 2020 Rule adopts the term "pecuniary factors" to avoid the terminology challenges associated with ESG.[171]

With respect to defined contribution ("DC") plans, the 2020 Rule impliedly accepts the notion that the "interests" of plan participants may include more than financial interests. As long as inclusion of an investment alternative for DC plan participants is based on an evaluation of pecuniary factors, the fiduciary is not precluded from considering an investment fund "merely because the fund, product, or model portfolio promotes, seeks, or supports one or more non-pecuniary goals."[172] The 2020 Rule reflects a commonsense understanding of ESG factors. An investor may seek both financial and non-financial benefits from an investment, as long as the financial benefits can be obtained without a financial concession related to the non-financial goals.[173] The problem, however, with the 2020 Rule's formulation of this "tie-breaker rule" is that the fiduciary must consider the funds indistinguishable from a financial perspective. Then, if the fiduciary chooses one fund over another based on collateral benefits, the fiduciary must document the analysis that led to that decision.[174] This documentation requirement may chill consideration of climate change and other ESG factors, even if those factors are financially material.[175]

The rules for qualified default investment alternatives ("QDIAs") are more restrictive. The DOL explains that "[p]aragraph (d)(2)(ii) of the final

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170. *Id.* at 72848 (describing the purpose of the regulatory action).

171. *Id.* at 72858 (explaining the imprecision and ambiguity of the term "ESG").

172. *Id.* at 72851.

173. *Id.* at 72846.

174. *Id.* at 72884. Subsection 2550.404a-1(c)(2) of the 2020 Rule says that if "the plan fiduciary is unable to distinguish on the basis of pecuniary factors alone, the fiduciary may use non-pecuniary factors as the deciding factor." *Id.* Then if the fiduciary uses non-pecuniary factors in making an investment decision, the fiduciary must document (i) why the investment decision could not be made based solely on pecuniary factors, (ii) how the selected investment compares to alternatives, and (iii) how the non-pecuniary factors used in making the decisions are consistent with the interests of the plan participants. *Id.*

175. Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights, 86 Fed. Reg. 57272, 57275 (Oct. 14, 2021) (to be codified at 29 C.F.R pt. 2550) ("The Department has also heard from stakeholders that the current regulation, and investor confusion about it, including whether climate change and other ESG factors may be treated as 'pecuniary' factors under the regulation, has already had a chilling effect on appropriate integration of climate change and other ESG factors in investment decisions, which has continued through the current nonenforcement period, including in circumstances that the current regulation may in fact allow.").

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rule expressly provides that in no circumstances may any investment fund, product, or model portfolio be 'added as, or as a component of, a qualified default investment alternative . . . if its investment . . . strategies include, consider, or indicate the use of one or more non-pecuniary factors.'"[176] A fund can be included as a QDIA if financially material ESG factors are considered as part of a risk-return analysis, but the fiduciary must document both the selection and the monitoring of the fund and compare the fund with similar "conventional" funds.[177] The additional burden may have the effect of limiting the availability of QDIAs that appeal to DC plan participants who seek both financial and non-financial benefits. The effect may also be to increase uncompensated systemic risk by limiting the availability of funds that consider ESG factors, particularly climate change, to reduce risk.[178]

F. The Biden Administration's Initial Steps

The new regulation was created and finalized in a hurry, with only thirty days for comments and an effective date just a week before the inauguration of a new U.S. President.[179] On inauguration day, January 20, 2021, President Joe Biden issued an executive order instructing agencies to review rules and executive orders that could harm public health or the environment.[180] The DOL's 2020 Rule was on the List of Agency Actions

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176. Financial Factors in Selecting Plan Investments, 85 Fed. Reg. 72846, 72865 (Nov. 13, 2020) (to be codified at 29 C.F.R. pts. 2509, 2550).

177. *Id.* at 72865–66.

178. As Mindy Lubber explained,

> The COVID-19 pandemic has been a devastating reminder of just how quickly lives and livelihoods can suffer and economies can falter when systemic risks are ignored. Investors understand climate change is a systemic risk that poses similar deadly and drastic consequences – including price volatility and asset value losses – across all sectors critical to our economy.

US SIF, Investor Organizations and Financial Industry Firms' Analysis of Public Comments, *supra* note 6.

179. *See* Financial Factors in Selecting Plan Investments, 85 Fed. Reg. at 72869, 72850 (establishing an effective date of January 12, 2021); *Watch Full Video: Biden Is Inaugurated as the 46th U.S. President*, N.Y. TIMES (Jan. 20, 2021), https://www.nytimes.com/video/us/politics/100000007558606/biden-inauguration-video.html (providing live coverage of President Biden's inauguration on January 20, 2021).

180. Exec. Order No. 13,390, 86 Fed. Reg. 7037 (Jan. 20, 2021).

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for Review.[181] On March 10, shortly before Marty Walsh was confirmed as Secretary of the Department of Labor,[182] the DOL issued an enforcement statement, announcing that the DOL would not enforce the final rule and would revisit the rule and publish additional guidance.[183] Critics of the 2020 Rule shared their thanks for this step, noting that the 2020 Rule had "ignored the large body of evidence that environmental, social and governance considerations and proxy voting are suitable for ERISA-governed retirement plans."[184] As Senator Patty Murray (D-WA), who serves as Chair of the Senate Health, Education, Labor and Pensions Committee, said in a statement, "Financial security is about planning for the long term, and the Trump Administration's requirement that people doing that ignore environmental, social, and governance criteria made about as much sense as telling someone planning a trip they can't look at a map."[185]

On May 20, 2021, President Biden signed Executive Order 14030, "Climate-Related Financial Risk."[186] The order recognizes the risk climate change presents to assets, investments, and companies in the United States and globally. The order describes the government's policy of advancing "accurate disclosure of climate-related financial risk" so that government agencies can act to mitigate the risk.[187] The order reaches across many

181. *Fact Sheet: List of Agency Actions for Review*, WHITE HOUSE (Jan. 20, 2021), https://www.whitehouse.gov/briefing-room/statements-releases/2021/01/20/fact-sheet-list-of-agency-actions-for-review/.

182. Walsh was confirmed on March 22, 2021. News Release, U.S. Dep't of Lab., Statement by Marty J. Walsh Following Senate Confirmation of His Appointment as 29th Secretary of the U.S. Department of Labor (Mar. 22, 2021), https://www.dol.gov/newsroom/releases/osec/osec20210322.

183. Department of Labor Statement Regarding Enforcement of Its Final Rules, *supra* note 9. Walsh had indicated that he would prioritize a review of the regulation if the Senate confirmed his nomination. Mark Schoeff, Jr., *DOL Nominee Walsh Raises Concerns About Trump Rule Curbing ESG Retirement Investing*, INVESTMENTNEWS (Feb. 24, 2021), https://www.investmentnews.com/dol-nominee-walsh-raises-concerns-about-trump-rule-curbing-esg-retirement-investing-203183.

184. *DOL Releases Statement on Non-Enforcement of Two Rules Pertaining to ESG and Proxy Voting in ERISA Plans*, US SIF (Mar. 10, 2021, 7:37 AM), https://www.ussif.org/blog_home.asp?Display=162.

185. Press Release, U.S. S. Comm. on Health, Educ., Lab. & Pensions, Murray Praises Biden Administration Move Not to Enforce Restrictions on Socially-Conscious Investing, Proxy Voting (Mar. 10, 2021), https://www.help.senate.gov/chair/newsroom/press/murray-praises-biden-administration-move-not-to-enforce-restrictions-on-socially_conscious-investing-proxy-voting.

186. Exec. Order No. 14,030, 86 Fed. Reg. 27967 (May 20, 2021).

187. *Id.* at 27967.

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government agencies, including the DOL. The Secretary of Labor is directed to identify actions that can be taken "to protect the life savings and pensions of United States workers and families from the threats of climate-related financial risk" and to consider "suspend[ing], revis[ing], or rescind[ing]" the 2020 Rule.[188] The Secretary must, within 180 days, report on the actions taken by the DOL.[189] The order makes clear the shift in perspective between the Trump and Biden administrations, and it reflects a recognition of the weight of financial evidence related to the need to consider climate risk to protect investments, especially retirement investments with a long-term time horizon.

G. The 2021 Proposed Rule: Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights

In October 2021, the DOL proposed changes to address confusion the 2020 Rule may have caused, including a perceived chilling effect that may have influenced consideration of climate change and other ESG factors even when financially material.[190] The DOL expressed concern that uncertainty over the 2020 Rule may have deterred pension fiduciaries from taking steps other investors would take to enhance investment performance or improve portfolio resilience against potential financial risks.[191] The DOL stated its belief that the 2021 Proposed Rule would "improve the current regulation and further promote retirement income security and further retirement savings."[192]

The 2021 Proposed Rule emphasizes the fiduciary duty of loyalty owed to plan participants: the fiduciaries "may not sacrifice investment return or take on additional investment risk to promote goals unrelated to the plan and its participants and beneficiaries."[193] The proposal clarifies that "material climate change and other ESG factors are no different than other 'traditional' material risk-return factors."[194] If a fiduciary concludes that climate change or another factor is material to an investment decision,

188. *Id.* at 27968–69. The order also requires the Secretary to assess "how the Federal Retirement Thrift Investment Board has taken environmental, social, and governance factors, including climate-related financial risk, into account." *Id.* at 27969.

189. *Id.* at 27969.

190. Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights, 86 Fed. Reg. 57272, 57275 (Oct. 14, 2021) (to be codified at 29 C.F.R pt. 2550).

191. *Id.*

192. *Id.* at 57276.

193. *Id.* at 57278.

194. *Id.* at 57277.

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whether an individual investment or a course of action, the fiduciary "can and should consider it and act accordingly, as would be the case with respect to any material risk-return factor."[195]

The 2021 Proposed Rule returns to the tie-breaker concept first articulated in IB 94-1 and rescinds the tie-breaker rule included in the 2020 Rule.[196] One concern with the latter is that it requires that investments be "indistinguishable" in terms of risk and return.[197] The DOL explains that a better approach is to consider whether the investments "equally serve the financial interests of the plan."[198] If they do, then collateral benefits can also be considered and can be determinative. The 2021 Proposed Rule also removes the requirement that the fiduciary document the analysis for a decision in which collateral benefits are considered.[199]

The 2020 Rule imposed restrictions on QDIAs, preventing a fund from being a QDIA if the fund used non-pecuniary factors in its objectives, even if the fund is economically prudent.[200] The 2021 Proposed Rule removes the restrictions.[201] QDIAs continue to be subject to the rules emphasizing the financial interests of participants that apply to all pension investments.[202]

The comment period for the 2021 Proposed Rule ended on December 13, 2021, with 895 comments received.[203] Some comment letters supported the Proposed Rule, some pushed the DOL to adjust it, and some simply opposed it altogether. The letters opposing the rule reflect misunderstandings of how financial analysts use ESG information and what the 2021 Proposed Rule provides. These letters in opposition range from individuals commenting "stop taking hard working American's [sic]

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195. *Id.*

196. *Id.* at 57278.

197. *Id.*

198. *Id.*

199. *Id.* at 57279.

200. *See supra* Section IV.E.

201. Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights, 86 Fed. Reg. at 57279.

202. *Id.* at 57280.

203. *See Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights - Proposed Rule*, U.S. DEP'T LAB., https://www.dol.gov/agencies/ebsa/laws-and-regulations/rules-and-regulations/public-comments/1210-AC03 (last visited June 10, 2022).

money"[204] to a comment submitted by the State of Utah ("Utah letter") and signed by attorneys general and other state officials from twenty-three states.[205] The Utah letter complains that the 2021 Proposed Rule "encourages, and may in fact require, a plan fiduciary to consider and prioritize non-pecuniary ESG factors when making investment decisions for retirement savings accounts. In other words, the Proposed Rule would allow employers and investment managers to invest employee retirement savings in a way that benefits social causes and corporate goals even if it adversely affects the return to the employee."[206]

In support of its statement, the Utah letter cites a provision in the Proposed Rule that a fiduciary may select investments "in part, for benefits apart from the investment return"[207] but fails to add that the Proposed Rule states that fiduciaries "may not sacrifice investment return or take on additional investment risk to promote goals unrelated to the plan and its

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204. Chuck Zupan, Comment on Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights (Dec. 7, 2021), https://www.dol.gov/sites/dolgov/files/EBSA/laws-and-regulations/rules-and-regulations/public-comments/1210-AC03/00523.pdf. Other letters said things like:

"Leave our retirement alone." Greg McNeil, Comment on Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights (Dec. 7, 2021), https://www.dol.gov/sites/dolgov/files/EBSA/laws-and-regulations/rules-and-regulations/publiccomments/1210-AC03/00366.pdf.

"Government should not promote funding for climate change. Let the market do what the market do." Jamal Khan, Comment on Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights (Nov. 10, 2021), https://www.dol.gov/sites/dolgov/files/EBSA/laws-and-regulations/rules-and-regulations/public-comments/1210-AC03/00039.pdf.

"I do not want my hard earned money directed to government directed woke companies. It is my money and I get to choose how that money is invested, keep your hands off of it." Jeffrey Kilgariff, Comment on Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights (Dec. 7, 2021), https://www.dol.gov/sites/dolgov/files/EBSA/laws-and-regulations/rules-and-regulations/public-comments/1210-AC03/00353.pdf.

205. Off. of the Utah Att'y Gen., Comment Letter on Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights (Dec. 13, 2021), https://www.dol.gov/sites/dolgov/files/EBSA/laws-and-regulations/rules-and-regulations/public-comments/1210-AC03/00794.pdf. Officials from the following states signed the letter: Alabama, Alaska, Arizona, Arkansas, Florida, Georgia, Idaho, Indiana, Kansas, Kentucky, Louisiana, Mississippi, Missouri, Montana, Nebraska, North Dakota, Ohio, Oklahoma, South Carolina, Tennessee, Texas, Utah, and West Virginia. *Id.* at 11–12.

206. *Id.* at 1.

207. *Id.* (citing Notice of Proposed Rulemaking, 86 Fed. Reg. 57272, 57272 (Oct. 14, 2021)).

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participants and beneficiaries."[208] As explained earlier in this section, the 2021 Proposed Rule continues to emphasize the duty of loyalty to the financial interests of pension participants and directs fiduciaries to consider financially material information.[209] The changes address a fiduciary concern that consideration of financially material ESG information is somehow prohibited.

Comment letters in favor of the 2021 Proposed Rule support changes that move the guidance "closer to a principles-based approach that does not uniquely target or single out (positively or negatively) ESG as compared to any other investment strategies, asset classes, or investment styles."[210] These letters agree with the 2021 Proposed Rule's focus on a fiduciary's duty to consider financially material information, in compliance with the duties of loyalty and prudence.[211] Some letters recommend removing examples that are ESG specific and removing the tie-breaker provision.[212] The comment letter submitted by Northern Trust explains that the inclusion of ESG-specific examples "differentiates ESG considerations from broad investment considerations. The neutral application of fiduciary principles and risks should not create a distinction between ESG considerations and

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208. Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights, 86 Fed. Reg. 57272, 57278 (Oct. 14, 2021) (to be codified at 29 C.F.R pt. 2550).

209. *See supra* text accompanying notes 193–95.

210. Lew Minsky, President & CEO, Defined Contribution Institutional Inv. Ass'n, Comment Letter on Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights (Dec. 9, 2021), https://www.dol.gov/sites/dolgov/files/EBSA/laws-and-regulations/rules-and-regulations/public-comments/1210-AC03/00324.pdf [hereinafter DCIIA Letter]; *see also* Julie Moret & Shundrawn Thomas, N. Tr. Asset Mgmt., Comment Letter on Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights (Dec. 13, 2021), https://www.dol.gov/sites/dolgov/files/EBSA/laws-and-regulations/rules-and-regulations/public-comments/1210-AC03/00769.pdf [hereinafter Northern Letter] ("[P]lan fiduciaries should have the ability to consider material ESG risks and opportunities . . . in a manner that is consistent with their duties of loyalty and prudence . . . . Investors can integrate ESG data to create a more holistic view of risks and opportunities, resulting in more informed investment decisions and resilient portfolios.").

211. *See, e.g.*, DCIIA Letter, *supra* note 210 (agreeing with DOL's attempt, through the 2021 Proposed Rule, "to remove barriers that may prevent the prudent integration of ESG factors into ERISA fiduciary decision-making").

212. Phoebe Papageorgiou & Timothy E. Keehan, Vice Presidents, Am. Bankers Ass'n, Comment Letter on Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights (Dec. 13, 2021), https://www.dol.gov/sites/dolgov/files/EBSA/laws-and-regulations/rules-and-regulations/public-comments/1210-AC03/00713.pdf (recommending removal of ESG-specific examples to avoid prejudice to factors not on the list and to avoid the need to update the list).

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other investment and financial considerations as drawing a distinction here may create undue confusion and potentially invite litigation."[213] The tie-breaker rule is described as "obsolete,"[214] and letters express the concern that the record-keeping required by the tie-breaker rule adds costs to the plans and therefore to their participants.[215]

Finally, the comment letter filed by the Intentional Endowments Network[216] recommends that the 2021 Proposed Rule address the duty of impartiality and recommends presumptive use of longer investment time horizons.[217] As described earlier,[218] fiduciaries for pension plans must consider the needs of already-retired participants and the needs of participants who will retire in the future. Guidance should directly address the duty of impartiality and the issue of longer time horizons. As the Teamsters' comment letter notes, "There are sound reasons for allowing fiduciaries to consider ESG factors, which can have a direct effect on the long-term health of a plan's assets."[219]

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213. Northern Letter, *supra* note 210. *See generally* Chantel Sheaks, Vice President of Ret. Pol'y, U.S. Chamber of Com., Comment Letter on Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights (Dec. 10, 2021), https://www.dol.gov/sites/dolgov/files/EBSA/laws-and-regulations/rules-and-regulations/public-comments/1210-AC03/00316.pdf (recommending removal of examples both because there are numerous other factors that fiduciaries should consider and because the list might suggest that the DOL expects fiduciaries to consider these factors, even when not prudent or possible).

214. Northern Letter, *supra* note 210 ("Provided that a fiduciary is guided by their duty of prudence, a criterion for defining a 'tie breaker' should be obsolete.").

215. *Id.*; *see also* DCIIA Letter, *supra* note 210.

216. The author participated in the drafting of this letter.

217. Keith Johnson et al., Intentional Endowments Network, Comment Letter on Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights (Dec. 13, 2021), https://www.dol.gov/sites/dolgov/files/EBSA/laws-and-regulations/rules-and-regulations/public-comments/1210-AC03/00714.pdf ("[T]he final rule should explicitly recognize a presumption that a long-term investment horizon will nearly always be an appropriate primary time horizon (although perhaps not the exclusive time horizon) for an ERISA fiduciary's strategic investment decision processes.").

218. *See supra* Section II.C.

219. Ken Hall, Gen. Sec'y-Treasurer, Int'l Bhd. of Teamsters, Comment Letter on Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights (Dec. 10, 2021), https://www.dol.gov/sites/dolgov/files/EBSA/laws-and-regulations/rules-and-regulations/public-comments/1210-AC03/00318.pdf.

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V. Cautions and Opportunities for Pension Fiduciaries

A. ESG, the Prudent Investor Standard, and the Duty of Loyalty

A question that occasionally surfaces lies at the intersection of the duty of loyalty and the duty to be a prudent investor. The duty of loyalty and the exclusive benefit rule both require the fiduciary to make decisions in the sole interests of the beneficiaries.[220] Those interests have been deemed to mean financial interests,[221] but as early as the 1994 guidance, the DOL recognized that other interests might be considered, as long as the consideration of those other interests did not result in a cost to the financial interests.[222] That is, investments that accomplished multiple goals were acceptable, as long as the investments did not accept concessionary returns. Thus, if the investment's risk-and-return assessment met the prudent investor standard, the fiduciary could properly consider collateral benefits in choosing the investment.[223] Alvin Lurie explained that it is unnecessary to treat consideration of non-financial benefits to plan participants as "contamination,"[224] because the prudent investor standard can continue to protect pensions from imprudent investments.[225]

Writing about the 2015 DOL guidance, Edward Zelinsky objected to consideration of collateral benefits that would benefit third parties.[226] He did not discuss whether a fiduciary could consider non-financial benefits to the plan participants themselves but rather assumed that any ETIs would benefit third parties.[227] Zelinsky also wrote about the 1994 guidance, and at that time he objected to the guidance as a step "in the reincarnation of the discredited theory of industrial policy" that would encourage the use of pension assets to allocate capital more wisely than the market.[228] He

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220. *See supra* Section II.A.

221. *See* Fifth Third Bancorp v. Dudenhoeffer, 573 U.S. 409, 421 (2014).

222. Interpretive Bulletin Relating to the Employee Retirement Income Security Act of 1974, 59 Fed. Reg. 32606, 32606 (June 23, 1994) (codified at 29 C.F.R. § 2509.94-1).

223. *See* Lurie, *supra* note 50, at 318.

224. *Id.* at 315.

225. *Id.* at 329.

226. Edward A. Zelinsky, *The Continuing Battle Over Economically Targeted Investments: An Analysis of the Department of Labor's Interpretive Bulletin 2015-01*, 2016 CARDOZO L. REV. DE NOVO 197, 198.

227. *See id.* at 202.

228. *See* Edward A. Zelinsky, *ETI, Phone the Department of Labor: Economically Targeted Investments, IB 94-1 and the Reincarnation of Industrial Policy*, 16 BERKELEY J. EMP. & LAB. L. 333, 334 (1995).

worried that ETIs would be "used to bail out failing industries and to satisfy constituencies promoting below-market investments."[229] At that time, Zelinsky thought the guidance was unnecessary because existing DOL policies on ETIs would "allow collateral benefits to be considered in making investment decisions where such investments are prudent and provide a competitive risk-adjusted return."[230]

Professors Max Schanzenbach and Robert Sitkoff have argued that any consideration of collateral benefits taints a determination that an investment is prudent under the prudent investor rule.[231] Because the duty of loyalty requires a fiduciary to focus on the sole interests of the beneficiaries, they conclude that investing for combined purposes—financial and non-financial—is unacceptable for a pension fiduciary.[232] They reach this conclusion by creating a dichotomy that may exist for some, but certainly not all, investors. They define "collateral-benefits" ESG investing to mean "ESG investing for moral or ethical reasons or to benefit a third party"[233] and "risk-return" ESG investing to mean investment decisions made solely for financial reasons.[234] Part of the difficulty of Schanzenbach and Sitkoff's approach may be that they view collateral-benefits ESG as the use of negative screens, while their definition of risk-return ESG is closer to the type of ESG integration described in this Article.[235] Many investors who use ESG integration have both financial and non-financial motives.

A better view is the one articulated in the DOL guidance itself: non-financial goals can be considered as long as an investment is prudent under a financial-only analysis.[236] The 1980 article by Langbein and Posner,

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229. *Id.* at 354.

230. *Id.* at 344.

231. *See* Schanzenbach & Sitkoff, *supra* note 3, at 385–86 ("ESG investing is permissible for a trustee of a pension . . . if: (1) the trustee reasonably concludes that the ESG investment program will benefit the beneficiary directly by improving risk-adjusted return; and (2) the trustee's exclusive motive for adopting the ESG investment program is to obtain this direct benefit.").

232. *See id.* at 384–85.

233. *Id.* at 389–90.

234. *Id.* at 397.

235. *See id.* at 398.

236. Interpretive Bulletin Relating to the Employee Retirement Income Security Act of 1974, 59 Fed. Reg. 32606, 32606 (June 23, 1994) (codified at 29 C.F.R. § 2509.94-1) (explaining that a plan fiduciary may invest plan assets in an ETI "if the ETI has an expected rate of return that is commensurate to rates of return of alternative investments"); Interpretive Bulletin Relating to the Fiduciary Standard Under ERISA in Considering Economically Targeted Investments, 80 Fed. Reg. 65135, 65136 (Oct. 26, 2015) (codified at

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described above,[237] raised concerns about "social investing" and the duty of loyalty, but the concerns were based on an assumption of greater transactional costs.[238] In their view, social investing was no more problematic than other actively managed investments.[239] The comments to the Uniform Prudent Investor Act ("UPIA"), written by Langbein as the Reporter for that uniform act, concur:

> No form of so-called "social investing" is consistent with the duty of loyalty if the investment activity entails sacrificing the interests of trust beneficiaries–for example, by accepting below-market returns–in favor of the interests of the persons supposedly benefitted by pursuing the particular social cause.[240]

Section 5 of UPIA states that trust law's duty of loyalty, the duty to act in the sole interest of the beneficiary, applies to a fiduciary acting as a prudent investor.[241] The comments quoted above explain that a fiduciary would be acting counter to the duty of loyalty if the fiduciary intentionally accepted below-market returns to benefit someone other than the beneficiaries. Thus, if an investment yields risk-adjusted returns equivalent to those otherwise obtainable, or if an investment is made to benefit the beneficiaries for whom the fiduciary is investing,[242] the fiduciary complies with the duty of loyalty.

ESG factors may be financially material and may be considered only as financial information, but a fiduciary may also use ESG factors in investment selections with the goal of supporting companies with, for

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29 C.F.R. § 2509.2015-01) (permitting ETI investments with collateral benefits "so long as the investment is economically equivalent . . . to investments without such collateral benefits"); Financial Factors in Selecting Plan Investments, 85 Fed. Reg. 72846 (Nov. 13, 2020) (to be codified at 29 C.F.R. pts. 2509, 2550) ("[W]hen making decisions on investments and investment courses of action, plan fiduciaries must be focused solely on the plan's financial returns . . . .").

237. Langbein & Posner, *supra* note 71.

238. *See id.* at 93.

239. *Id.*

240. UNIF. PRUDENT INV. ACT § 5 cmt. (UNIF. L. COMM'N 1994).

241. *Id.* § 5 ("A trustee shall invest and manage the trust assets solely in the interest of the beneficiaries.").

242. If the fiduciary is investing for a charity, an investment related to the mission of the charity may comply with the duty of loyalty even if risk-adjusted returns are lower than comparable investments. *See* Susan N. Gary, *Is It Prudent to Be Responsible? The Legal Rules for Charities that Engage in Socially Responsible Investing and Mission Investing*, 6 NW. J.L. & SOC. POL'Y 106, 123 (2011).

example, fair labor practices or strong environmental records. Those companies may generate positive externalities that benefit the pension participants and their beneficiaries indirectly. An investment in a company with strong ESG ratings may perform better financially and may also contribute to climate solutions or other benefits. A pension fiduciary should not worry that considering non-financial information somehow taints the investment process. As long as investments are prudent, made in compliance with the prudent investor standard and the DOL guidance, the investments will comply with the fiduciary's duties, including the duty of loyalty.

For purposes of the fiduciary duty to be a prudent investor, the key is whether the strategy used results in a necessary cost to the portfolio. An investor need not be driven purely by financial interests if the investment strategy does not involve a concessionary return (or higher, uncompensated risk). Any investment strategy may result in an unforeseen loss, but the prudent investor standard is not applied in hindsight.[243] For purposes of the prudent investor rule, the question is whether an investment strategy is entered into with an acceptance of lower financial return or higher risk in exchange for non-financial benefits.

B. Need to Consider Material Information

ERISA and other pension fiduciaries need to be aware of the role material ESG factors play in investment performance. With increasing evidence that these non-traditional factors have financial impacts on risk and return, attention to these factors becomes a part of a prudent evaluation of funds and products.[244] Documentation of the selection process is important, both to demonstrate consideration of material factors, including ESG factors, and to demonstrate the pecuniary basis for selecting a fund or product.[245] Fiduciaries who have been wary of anything labeled ESG due to

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243. *See* UNIF. PRUDENT INV. ACT § 8.

244. *See* GORDON L. CLARK ET AL., UNIV. OF OXFORD & ARABESQUE PARTNERS, FROM THE STOCKHOLDER TO THE STAKEHOLDER: HOW SUSTAINABILITY CAN DRIVE FINANCIAL OUTPERFORMANCE 12 (rev. 2015), https://arabesque.com/research/From_the_stockholder_to_the_stakeholder_web.pdf.

245. *See Final ERISA Rules Circle Back to Allow ESG Investing*, *supra* note 6 ("Based on this guidance [the 2020 Rule] fiduciaries should proceed cautiously and with formal documented processes demonstrating their evaluation of pecuniary factors."). Whether or not the 2020 Rule is enforced, pension fiduciaries should document the pecuniary reasons for investment selections.

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an outdated understanding of the pecuniary importance of these facts may need to reevaluate their selection processes.[246]

An article in *The Asset* quoted Mark Konyn, Group Chief Investment Officer at AIA Group, as saying, "Investors are going to have to be much more disciplined about understanding the investment impact of changing values in society."[247] Konyn expressed concern about protecting portfolios from stranded assets, quoting a BlackRock report stating that "asset owners may be confronted with asset write-downs (e.g., in the case of fossil-fuel companies) if they ignore the growing trend [in sustainable investing] for too long."[248] As the Reinhart law firm explains, "Fiduciaries may want to consider whether there are new opportunities to capture improved returns or reduce risk exposures through carefully selected ESG investment approaches."[249] Pension fiduciaries, like other fiduciaries, need to pay attention to developments in the investment landscape.

Pension fiduciaries may rely on investment advisors to assist in the selection of funds and products. The prudent investor standard permits delegation, but a prudent investor must exercise reasonable care, skill, and caution in (1) selecting the advisor; (2) establishing the terms of the delegation, consistent with the purposes of the fund being invested; and (3) reviewing performance and compliance by the advisor.[250]

The duty to monitor is ongoing.[251] As knowledge about the materiality of information develops and investment practices evolve, the fiduciary's duties include evaluation of the advisors' expertise in connection with these changes.[252] As part of the monitoring process, pension fiduciaries can evaluate their investment advisors' knowledge and expertise in managing climate risk and other systemic risk.

C. Opportunities for Reducing Risk or Increasing Return

Some financial benefits of integrating ESG factors in investment analysis lie in the use of information not yet reflected in the market price of stock.

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246. *See id.*

247. *Investors Warned of Stranded Assets as ESG Gains Traction*, ASSET (Jan. 26, 2021), https://www.theasset.com/article-esg/42755/theasset.com.

248. *Id.*

249. *Final ERISA Rules Circle Back to Allow ESG Investing*, *supra* note 6.

250. UNIF. PRUDENT INV. ACT § 9 (UNIF. L. COMM'N 1994).

251. Tibble v. Edison Int'l, 575 U.S. 523, 529 (2015).

252. *See Final ERISA Rules Circle Back to Allow ESG Investing*, *supra* note 6 ("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.").

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As the information becomes more widely known, the benefit of this "extra" information (alpha) will be reduced. In addition, if the benefits of paying attention to behaviors reflected in E, S, and G information becomes known in an industry, more companies will adjust their behavior. For example, resources companies facing public concerns about climate change will develop strategies for energy transition to sources of energy with reduced carbon emissions. If improved employee conditions produce strategic benefits, more companies will improve conditions for their workforces. Individual comparisons may be less apparent if all companies within a sector take ESG risks and opportunities seriously.[253]

The value of considering material ESG factors is not simply in using information that other investors have not yet incorporated. As ESG reporting has improved and ESG information has become more widely available, studies continue to show better or neutral returns when a fund using ESG integration is compared with a traditional fund.[254] Material ESG information can show a company's strength, and the stock price may ultimately reflect some of that information, but ESG information may suggest uncompensated risk, and the market price may not adjust for that information. For example, evidence of safety and environmental violations by British Petroleum ("BP") existed for two years before the Deepwater Horizon oil disaster.[255] The stock price did not reflect the violations, but an investor considering material ESG factors would have noted the risk associated with those violations. When the disaster occurred, the price of BP stock fell by 50%, and for a five-year period following the oil spill, BP underperformed a peer group of oil companies by 37%.[256] The ESG

253. MARTIN GROSSKOPF, AGF, ESG 2.0 – A POST-COVID-19 ROADMAP FOR THE EVOLUTION OF ESG 5 (June 26, 2020), https://www.agf.com/_files/pdf/insights/fund1200-06-20-e-esg-2-0.pdf.

254. *See, e.g.*, Curtis, Fisch & Robertson, *supra* note 2, at 402 (noting that "an increasing number of scholars and policymakers claim that sustainable or ESG investing is associated with better economic performance"); WHELAN ET AL., *supra* note 98, at 2; Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights, 86 Fed. Reg. 57272, 57289–92 (Oct. 14, 2021) (to be codified at 29 C.F.R pt. 2550) (describing studies analyzing financial risks or higher profitability related to climate change and other ESG factors).

255. CLARK ET AL., *supra* note 244, at 14.

256. *Id.*

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information could have been used to identify a significant, uncompensated financial risk.[257]

Some ESG information reflects systemic risk (beta).[258] Risks that affect the market as a whole, such as climate change, political instability, income inequality, and global financial crisis, may have significant long-term financial consequences. For example, clean water is a systems-level issue.[259] In the past, companies could use water and then release contaminated water without financial consequence, externalizing costs incurred in the production process.[260] The cost of cleaning the water was borne by taxpayers or some other company that needed clean water and paid to have it cleaned.[261] If regulations force companies to internalize the cost of reducing contamination in water they use and release, the internalized costs will affect the companies' bottom lines.[262] Systems-level considerations, such as strategies that consider E, S, and G resources, may allow an investor to manage systemic risk and improve long-term returns.[263]

D. Duty of Impartiality and Long-Term Risk

A pension plan serves participants who are currently taking distributions and those retiring in the future, perhaps decades in the future. In compliance

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257. *See* Raj Thamotheram & Maxime Le Floc'h, *The BP Crisis as a "Preventable Surprise": Lessons for Institutional Investors*, ROTMAN INT'L J. PENSION MGMT., Spring 2012, at 68, 70.

258. *Id.* at 70–71; LUKOMNIK & HAWLEY, *supra* note 57, at 32–45 (describing the importance of systemic risk (beta) in driving investment return).

259. STEVE LYDENBERG, THE INV. INTEGRATION PROJECT, SYSTEMS-LEVEL CONSIDERATIONS AND THE LONG-TERM INVESTOR: DEFINITIONS, EXAMPLES, AND ACTIONS 2 (2017), https://tiiproject.com/wp-content/uploads/2017/03/Systems_Level_Considerations_Long_Term_Investor.pdf [https://perma.cc/4ACW-548U]. Lydenberg, of the Investment Integration Project, created guidelines for incorporating systems-level considerations into investment decision-making. *Id.* at 6–9. He identifies six issues as ones that have substantial long-term financial implications: climate change, access to fresh water, societal well-being (poverty alleviation and access to healthcare), human and labor rights, stability and credibility of markets and financial systems, and transparency of sustainability data. *Id.* at 9–17.

260. *See* Gary, *Best Interests in the Long Term*, *supra* note 69, at 782–84 (discussing externalization of costs).

261. *Id.* at 782.

262. *See id.* at 782–84.

263. *See* Thamotheram & Floc'h, *supra* note 257, at 68–71 (explaining current problems with short-term thinking and narrow conception of risk and advocating for greater attention to systemic risk and "ESG beta").

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with the duty of impartiality, a pension fiduciary must invest on a long-term basis to ensure the viability of the fund for those future retirees.[264] ESG integration is well suited for managing long-term risk. As David Hess explains, "[T]he ESG movement is less about the *values* investing commonly associated with the socially responsible investing ('SRI') funds, and more about long-term *value* investing focused on reduced risk and improved shareholder value."[265] Factors associated with climate change, excessive executive compensation, workforce problems, and human rights violations may not be reflected in short-term financial metrics but may be material in evaluating long-term risk.

E. ESG Options May Increase Participation by Millennials

Unrelated to investment performance, a pension plan that offers investment options that include perceived non-financial as well as financial benefits may be appealing to millennial employees. Millennials represent a large demographic, and they are now at the ages (between twenty-six and forty-one in 2022) when they may be thinking more about planning for retirement.[266] Studies have shown that a significant percentage of millennials say they want to tailor investments to values or that they are interested in sustainable investing.[267] Providing investment options that appeal to millennials may encourage them to invest within the pension framework.[268] As Russell Heller, who submitted an individual comment to the 2021 Proposed Rule, explained, "I find myself trapped between investing in funds that do not support my values and not saving for retirement—this is not a choice I should be forced to make. More people

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264. *See supra* Section II.C.

265. David Hess, *Public Pensions and the Promise of Shareholder Activism for the Next Frontier of Corporate Governance: Sustainable Economic Development*, 2 VA. L. & BUS. REV. 221, 223 (2007).

266. *See* MSCI ESG RSCH. LLC, SWIPE TO INVEST: THE STORY BEHIND MILLENNIALS AND ESG INVESTING 2 (2020), https://www.msci.com/documents/10199/07e7a7d3-59c3-4d0b-b0b5-029e8fd3974b (explaining that Pew Research Center analysis defined millennials as those born between 1981 and 1996).

267. *Id.* at 8–10 (listing thirteen studies indicating millennials' interest in ESG investing); Julian Seelan, *Sustainable Investing: The Millennial Investor*, INVS. & WEALTH MONITOR, Mar./Apr. 2019, at 44, 46, https://investmentsandwealth.org/getattachment/bbdef004-2fe8-4e71-a445-918a270b5ff7/IWM19MarApr-TheMillennialInvestor.pdf ("86% of millennials are interested in sustainable investing[.]").

268. *See* Goforth, *supra* note 64 (quoting Edward Farrington, Executive Vice President, Institutional and Retirement, at Natixis Investment Managers) ("Our research also indicates ESG investing options can encourage more participation in retirement plans.").

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will save more towards their retirements if they are given access to funds that align with their values."[269]

VI. For the Future: Should "Benefits" Include Non-Financial Benefits?

The DOL's 2020 Rule accepts that ESG information has financial materiality and acknowledges that non-financial benefits can be considered in choosing funds or products, as long as the actual choice is made for financial reasons.[270] The 2021 Proposed Rule clarifies this position and removes some of the confusion surrounding the use of financially material ESG factors.[271] As discussed, investment options for QDIA plans are more restricted under the 2020 Rule,[272] but the 2021 Proposed Rule will remove the restrictions if the rule becomes final.[273]

A question for the future is whether a fiduciary investing for a beneficiary's "interests" must always prioritize financial interests over non-financial interests. The question is a difficult one for pension fiduciaries because pensions operate for large numbers of participants and their beneficiaries. A determination of non-financial interests is more difficult than simply trying to invest for the highest possible return with the lowest risk. Perhaps it is enough to consider the non-financial interests as collateral and secondary to the financial interests, which is the current state of fiduciary law. But if, as Lukomnik and Hawley argue, mitigating systemic risks to financial, social, and environmental systems can create value in the capital markets and keep the systems functioning in the future,[274] then investing with an eye to those systemic benefits may be appropriate, even for a fiduciary.

In addition, some individuals and organizations want to be able to invest in ways that reflect their values. A fiduciary cannot use the fiduciary's own values in making determinations for beneficiaries, but if the beneficiaries'

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269. Russell Heller, Comment on Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights (Nov. 12, 2021), https://www.dol.gov/sites/dolgov/files/EBSA/laws-and-regulations/rules-and-regulations/public-comments/1210-AC03/00042.pdf.

270. Financial Factors in Selecting Plan Investments, 85 Fed. Reg. 72846, 72871 (Nov. 13, 2020) (to be codified at 29 C.F.R. pts. 2509, 2550).

271. *See* Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights, 86 Fed. Reg. 57272, 57278, 57289 (Oct. 14, 2021) (to be codified at 29 C.F.R pt. 2550).

272. *See supra* text accompanying note 200.

273. *See supra* text accompanying note 201.

274. *See* LUKOMNIK & HAWLEY, *supra* note 57, at 110.

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values are known to the fiduciary, the fiduciary should be able to consider those values. Both Delaware and Oregon have added provisions to their prudent investor statutes to permit fiduciaries to do so.[275] These statutes may reflect a growing awareness that for some people, financial return is not the only return that matters.[276]

While the Delaware and Oregon statutes make consideration of values acceptable in the context of a private family trust, consideration of values is not feasible for a pension, unless the pension is managed for employees of a single organization with like-minded participants. For example, some religious organizations want to invest the pensions they manage in a manner that aligns with their values.[277] The 2020 Rule includes a discussion of several comment letters that raised the issue of investing in alignment with religious values.[278] One commenter worried that the 2020 Proposed Rule "would have the practical effect of unnecessarily limiting access by people of faith to prudent pension investment options aligned with their religious beliefs" and argued that, as proposed, the rule violated the Religious Freedom Restoration Act.[279] Another commenter raised the issue of religious organizations using negative screens to remove "sin stocks" from their portfolios.[280] After discussing the comments, the 2020 Rule states that, as revised, the rule provides enough flexibility for a religious organization to address these concerns.[281] In response to the 2020 Rule, Albert Feuer advocates the adoption of ERISA regulations or other

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275. DEL. CODE ANN. tit. 12 § 3302(a) (2022); OR. REV. STAT. § 130.755(3)(j) (2021).

276. *See* MSCI ESG RSCH. LLC, *supra* note 266, at 2 ("The collection of studies . . . suggested that millennials . . . are interested in directing their investments toward companies with good ESG records. This reflects a desire for their money not just to earn a return but to align with their personal values and contribute to the social good.").

277. Albert Feuer, *Ethics, ESG, and ERISA: Ethical-Factor Investing of Savings and Retirement Benefits*, 47 Tax Mgmt. Comp. Plan. J. (BNA) 212, 216 (2019) (describing faith-based investing as the earliest form of what Feuer calls ethical investing). Feuer defines "ethical-factor investing" as "using ethics as a factor to determine whether to acquire, dispose of, or how to exercise ownership rights in an equity or debt interest in a business enterprise." *Id.* at 213.

278. Financial Factors in Selecting Plan Investments, 85 Fed. Reg. 72846, 72869 (Nov. 13, 2020) (to be codified at 29 C.F.R. pts. 2509, 2550).

279. *Id.*

280. *Id.*

281. *Id.* at 72869–70.

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interpretative guidance that would permit open consideration of ethical factors.[282]

VII. Conclusion

As the use of ESG investing by financial analysts has grown, the use of ESG investing by pension fiduciaries becomes a way to act in line with the duty to act as a prudent investor when managing pension assets. If a prudent investor considers financially material information that affects the risk and return of investments, then a decision to exclude ESG factors because those factors appear non-traditional is contrary to the prudent investor standard. At a minimum, consideration of financially material ESG factors is already part of the fiduciary duty to be a prudent investor.

For now, the DOL has confirmed that fiduciaries may consider material ESG information.[283] The reality, reflected in the comments submitted to the DOL, is that ESG factors are already part of mainstream investing. The 2020 Rule restricts what can be offered as a QDIA to DC plan participants, but the 2021 Proposed Rule will remove those restrictions so that fiduciaries can have more control in deciding how best to serve the people for whom pensions are provided.[284]

ESG factors may provide non-financial as well as financial benefits to plan participants and beneficiaries. For pension fiduciaries, consideration of material ESG factors for both financial and non-financial reasons is appropriate and not a violation of the duty of loyalty, as long as the choice of investments is made for sound financial reasons. The 2021 Proposed Rule confirms this view of the duties of pension fiduciaries.

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282. Albert Feuer, *Ethics, Earnings, ERISA, and the Biden Administration*, 62 Tax Mgmt. Memorandum (BNA) 23, 28 (2021).

283. Financial Factors in Selecting Plan Investments, 85 Fed. Reg. at 72871; Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights, 86 Fed. Reg. 57272, 57278, 57289 (Oct. 14, 2021) (to be codified at 29 C.F.R pt. 2550).

284. Financial Factors in Selecting Plan Investments, 85 Fed. Reg. at 72864–65; Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights, 86 Fed. Reg. at 57278.

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