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# US Department of Labor – Slapped by the Invisible Hand

Leaving only 30 days to comment, the Employee Benefits Security Administration under the US Department of Labor proposed, on June 30, 2020, a rule change to Title I of ERISA *"to confirm that ERISA requires plan fiduciaries to select investments and investment courses of action based solely on financial considerations relevant to the risk-adjusted economic value of a particular investment or investment course of action."* Just on the face of it this reads as an unnecessary overemphasis of what is already covered in ERISA section 404(a)(1)(A) which requires fiduciaries to act with *"complete and undivided loyalty to the beneficiaries"* and making clear that these actions *"be made with an eye single to the interests of the participants and beneficiaries."* For those following along at home in quarantine, you can find the proposed rule as "Financial Factors in Selecting Plan Investments, RIN 1210-AB95".

What this really targets are ESG investment options in retirement plans, aimed squarely at what they characterize as "nonpecuniary" benefits. This is not DOL's first time taking us down this path, but it might be the most aggressive so far. We can trace this back to a series of interpretive bulletins, assistance bulletins and rules starting with IB 94-1, continuing with IB 2008-01, 29 CFR2509.2015-01, and most recently with FAB 2018-01. The meta message in all of this is that **certain individuals and companies do not like when the invisible hand of the market slaps them in the face.** Right now, there is a groundswell of interest in and capital flow toward sustainable investment options which in many cases specifically express the collective desire of shareholders to improve corporate behavior in ESG terms. Given the massive size and scope of just employer-sponsored retirement plans, and the fact that the Investment Company Institute has quantified through their own studies that, over the last two decades, 70% or more of investors' first experiences purchasing a mutual fund is through one of these plans, continued adoption poses a structural challenge to those who would resist this shareholder enfranchisement trend.

The investment, advisory, academic, NGO and even State government communities erupted. By some counts more than 1,500 responses poured in to the EBSA even with such a truncated comment period, and not many were supportive. The magnitude of the reaction alone was a demonstration that the Dept. of Labor landed on the wrong side of history. A lot of work has been done on the fundamental and material investment merits of environmental, social and governance considerations in the selection of securities and construction of portfolios over a number of years, and it appears as though the government got the whole library dumped on their front stoop.

For purposes of this discussion, we are going to stipulate to all of that great work. ESG is at a bare minimum not depletive to investment outcomes, and a growing body of evidence indicates that it is additive in a number of ways. For our discussion, we would like to raise two additional concerns in the DOL's reasoning that go beyond whether ESG is contributory or destructive to risk and return.

**Undivided loyalty to the beneficiaries**

There is an interesting dissonance between the strong language in ERISA section 404(a)(1)(A) and the further interpretation in the context of ESG in the newly proposed rules. Decisionmaking is made with an eye single to the interests of the participants and beneficiaries, but only the interests as further defined by the DOL, and not actually those participants and beneficiaries. That in itself seems excessively heavy-handed particularly coming from an Executive Branch that has been on a de-regulation bender.



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This is the same DOL that, in another context, went the opposite direction and liberalized the fiduciary standard and issued an opinion letter on June 3rd of this year opening the door to private equity in defined contribution plans (to Jon W. Breyfogle, Esq., Groom Law Group, as counsel to Pantheon Ventures LP and Partners Group, Inc. from Louis J. Campagna, Chief, Division of Fiduciary Interpretations Office of Regulations and Interpretations). There is a panoply of challenges private equity presents to the fiduciary discharging her duties under section 404, and **it raises the question of which beneficiaries are receiving undivided loyalty in plans where beneficiaries are to be treated uniformly**. The DOL brings it all down to pecuniary vs. non-pecuniary considerations. Put another way, risk/return vs. anything else that is not risk/return.

The proposed rule at its core says if you cannot draw a straight line from ESG considerations to risk and return, they must be put to the side, only to be used (maybe) as a tie-breaker all other things being truly equal. This is where many of the commenters piled on, drawing those lines with fat magic markers. The good news on this count is that the material financial benefits of ESG are demonstrable, so as high as the bar is, it can still be surmounted. This still leaves room for the non-pecuniary benefits because they are a byproduct of the method of investing, and not driving fears of concessionary returns.

But… here is where the law of unintended consequences comes into play.

**Every other fund**

It is clear by frequent reference that this rulemaking is targeted at ESG investments. However, the language establishing the parameters is both very precise and very (unintentionally) broad at the same time. DOL is attempting to carve out ESG as a special class of investments by being very particular about focusing on the pecuniary vs. non-pecuniary question. The criteria to do so make it clear that the highest calling of the fiduciary is to pursue a very rigorous, detailed, and well documented analytic and comparative process that will reveal whether the ESG investment, based purely on pecuniary measures, stands as the best, or equal to the best, of what the rest of the marketplace has to offer.

Noble intent.

What about the rest of the marketplace? If you were to take an inventory of the astonishing array of mutual funds, collective funds, variable insurance trusts, and other vehicles that appear in employer-sponsored defined contribution retirement plans, you would find a very, very high percentage of those investments present in one or more retirement plans. Statistically, they cannot possibly all be the best by the standard established by this new rulemaking. **Is the DOL actually proposing that ESG funds be held to a higher standard than any other possible investment option already held in plans covered by ERISA?** That sounds indefensible in court.

We have established the intent of the rule is to hold fiduciaries to exclusively considering the pecuniary attributes of a fund, at least up to the point you are comparing the best with the best, and then the other considerations may be able to come in to break the tie. So if they are not carving out a separate and higher standard for ESG funds, these procedures would apply broadly across the entire constellation of ERISA-governed defined contribution plans, and then you have likely unleashed a compliance cataclysm because, as we just established, all of those thousands of funds cannot possibly all be demonstrably and quantitatively the best. Everybody in the fiduciary food chain would have to get to work re-underwriting thousands of funds and likely hundreds of thousands of plans and evaluate every single investment option through that same process, which leapfrogs from the current standard of quality, suitability and appropriateness to provable superiority. From there, there would be a serious question of who would be willing to assume fiduciary responsibility if that is the threshold for having discharged that responsibility. What trustee, advisor, consultant, accountant, HR officer, recordkeeper or actuary will attest to that level of comparative superiority?



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**What is the path out of this?**

Let us say the DOL insists they are not creating a special class, and that their intent is not to raise the bar across the entirety of the public capital markets. They clarify (unnecessarily given how many times they have already stated and codified it) that they are purely guiding on not bringing those non-pecuniary considerations into the analysis and selection process. All other things remain the same. Where might the safe harbor be from an ESG point of view?

It would seem that a "blind audition" process could be instituted where ESG funds could be introduced into plan searches that are conducted as before (based on reasonableness), except the search is agnostic or even blinded to all things non-pecuniary, including ESG, but also considerations like firm size, branding, participant education, and cost sharing. If the ESG option qualifies on the investment merits alone, as the DOL would seem to desire, so be it. That would be a level playing field which would equitably include ESG funds as candidate investments without having to raise the standard so high it upsets the equilibrium of every DC plan covered by ERISA.

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This paper was produced in partnership with Regenerative Investment Strategies, LLC.

*For more information and insight on the role of the fiduciary in inclusion of ESG and impact investing for retirement plans, foundations, endowments, families, and other types of asset owners, reach out to Wilde Capital Management, LLC at (866) 894-5332, or contact@wildecapitalmgmt.com.*