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‘Do-Good’ Investing Rule Sets Course for Wary 401(k) Investors

By Austin R. Ramsey
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- Guidance could pave way for more investing

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‘Do-Good’ Investing Rule Sets Course for Wary 401(k) Investors

By Austin R. Ramsey 2021-02-10T10:52:52000-05:00
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Guidance could pave way for more investing

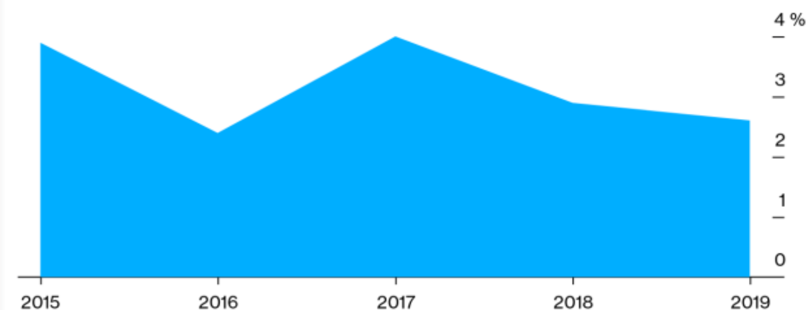
The U.S. Labor Department’s financial factors rule, widely regarded as a rebuke of environmental, social, and governance funds, actually could serve to persuade skittish fiduciaries to incorporate socially conscious investments, attorneys and consultants say.

The so-called “do-good” investing rule requiring fiduciaries to invest based solely on financial considerations hasn’t had the chilling effect on ESG investing that the former administration may have sought. The market for these kinds of investments has far outgrown Labor Department reminders that financial factors should prevail, and it could, instead, spur on typically reticent 401(k) investors.

“The rule we’ve been left with changes how all investment fiduciaries are supposed to look at all investment decisions,” said Ivelisse Berio LeBeau, a partner at The Wagner Law Group LLC in Miami. “It is going to change how retirement plan fiduciaries make investment plan decisions in general, leveling the playing field for ESG investments because they go through the same analysis.”

As President Joe Biden reviews the ESG rule, attorneys and fiduciaries want the administration to take a narrow, targeted deregulatory approach. The DOL could preserve the clarity and authenticity the rule provides while easing restrictions on default investments or proxy voting powers, they say.

Just under 2.5% of 401(k) plans in the U.S. offer ESG funds and 0.1% of plan assets are held in those funds, according to the most recent Plan Sponsor Council of America member survey. Yet more than a quarter of all professionally managed assets had ESG mandates in 2018, up from 11% in 2012, a Deloitte analysis found. Socially conscious assets have never been so profitable; the S&P 500 ESG Index has outperformed the entire S&P 500 benchmark by nearly 7% this year alone.



Seeking Clarification

DOL-protected retirement savings historically have lagged behind other investment vehicles in the market—a consequence of stricter record-keeping requirements and fiduciary standards. Class actions under the Employee Retirement Income Security Act of 1974 have been on the rise, fueled, in part, by fee disputes associated with 401(k)-style plans.

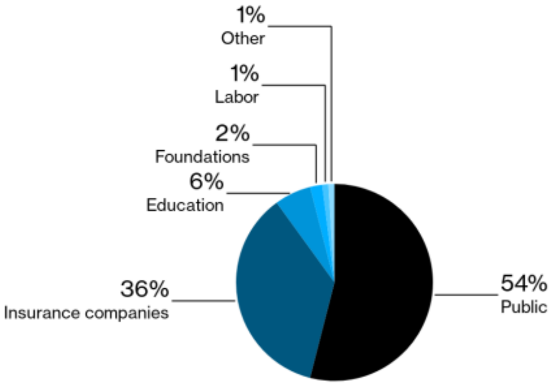
Plan fiduciaries are less inclined to incorporate progressive investment strategies for fear that they may expose themselves to litigation, said George Michael Gerstein, a co-chair of the Fiduciary Governance and ESG groups at Stradley Ronon Stevens & Young LLP in Washington.

“In terms of ERISA governance, it’s more gradual and methodical, and plan sponsors are generally reluctant to rapidly change course if they were on a course of action to begin with,” he said.

Investment managers and plan sponsors have wanted consistent evidence and clear guidance on the role ESG factors can and should play in choosing their investments and steering their funds, but guidance has fluctuated with Democratic and Republican administrations.

Former President Barack Obama reverted to the “everything being equal” test in 2015 and expanded the kinds of considerations fiduciaries could consider when choosing ESG investments. Then, in 2018, former President Donald Trump’s DOL issued a field assistance bulletin discouraging fiduciaries from discerning ESG factors as “economically relevant,” forbidding them under ERISA’s qualified default investment alternative regulation.

An ESG rule the Trump administration proposed in June drew thousands of comments from fiduciaries concerned about excessive documentation costs and dubious reasoning. The rule, said then-Labor Secretary Eugene Scalia, sought to remind the ERISA-governed retirement community that “private employer-sponsored retirement plans are not vehicles for furthering social goals or policy objectives that are not in the financial interest of the plan.”



Source: US SIF Foundation

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Roadmap to Options?

The department walked back its approach in the final rule, eliminating all mentions of ESG and relying instead on a specific distinction between "pecuniary" and "non-pecuniary" factors—whether or not investment decisions are in a participant or beneficiary's financial interests. By doing so, the DOL opened the door for the consideration of ESG factors on economic principles.

"It's a difference without a distinction," LeBeau said. "It could end up having the effect of encouraging ESG investing. It gives a roadmap for how those fiduciaries can offer investment options that consider ESG or other collateral benefits."

Simply by delineating how the former administration would judge investments outside the traditional scope of financial gains and losses, the department set a standard once-leery investors could use to consider the use of ESG factors, she said.

This comes at a time when the data in favor of ESG considerations is more sophisticated and plentiful than ever before, said Bonnie Treichel, chief operating officer and co-founder of ZUNA LLC, an investment adviser in Portland, Ore. Now more than ever, investors are considering how climate change may add risk or promise future returns; how a company treats its employees may be a factor in the bottom line.

The rule also clarified that the strict pecuniary obligations it would apply to ERISA plans would not extend to self-directed "brokerage windows" within those plans, meaning individual retirement investors taking advantage of brokerage accounts offered by their employers could make riskier investments at will.

Future funds likely won't be classified as ESG or not—they'll incorporate ESG considerations much like they do any other, Gerstein said.

Biden has already signaled his intentions on climate policy with a spate of executive orders, said Stephanie Moersfelder, associate director of business development and client services at Impax Asset Management Group Plc, an environmentally focused asset manager.

The administration could ease burdens by eliminating explicit ESG restrictions on the kinds of funds where participants' investments go when they don't select any from the plan menu, Moersfelder said. The Biden administration also could take a more robust de-regulatory approach to Trump's proxy voting rule, which created a weighty six-part test for fiduciaries to determine how to use their shareholder powers.

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