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ESG, the DOL and a New World For 401ks

By: Hanna Schriner
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Defined contribution plan sponsors may understandably be experiencing a sense of whiplash as it relates to environmental, social and governance ("ESG") factors and the extent to which they're allowed to consider non-financial factors as part of their fiduciary duties. Over the past five years, the Department of Labor (DOL) has issued interpretive guidance in favor of ESG considerations; then, in 2020, it amended its "investment duties" regulations to reverse previous guidance; and then, this past October, proposed a new rule, that yet again opens the doors for fiduciaries to consider ESG when selecting investments or exercising shareholder rights.

While the back and forth may generate confusion or, worse, regulatory risk for plan sponsors beholden to ERISA's prudence and loyalty requirements, the latest proposal from the DOL provides affirmation this is the direction regulators are moving. ESG, which has gained so much traction in other, non-ERISA categories, seems here to stay, opening the door to allow fiduciaries to weigh the non-financial factors that will influence long-term investment performance.

But here come the caveats about ESG and 401(k)s: Despite the groundswell of interest in ESG investments, adoption in the defined contribution space will likely come slowly until there's more clarity from the DOL and other regulators. Moreover, while progress has been made in the development of ESG data and consolidation among the sustainability frameworks, more uniform industry metrics will be needed to evaluate ESG investment options and provide appropriate benchmarks. And another major conundrum remains: The fundamental duties of fiduciaries — prudence and loyalty — have not changed. In that regard, for plan sponsors, it's a new day with the same constraints.

While the comment period expired on December 13, the proposed rules seem vaguely prescriptive about ESG considerations, as has been pointed out in comments to the DOL by the Investment Consultants Sustainability Working Group - United States (of which Meketa is a founding member) and others. To wit, the current draft of the rule states: "The projected return of the portfolio relative to the funding objectives of the plan, which may often require an evaluation of the economic effects of climate change and other environmental, social, or governance factors on the particular investment or investment course of action ..."

So, is it "always required" or "may be required?" Confusion will ensue unless more clarity is forthcoming. Moreover, the proposed rules would come with the traditional strings attached: As long as fiduciaries remain true to those regulations currently in place, ones that have been for years, then they can consider ESG factors. Thus, more guidance from the DOL would be valuable to articulate how plan sponsors can adopt ESG in ways that won't expose them to additional lawsuits.

Then there's the challenge of sorting what's good and what's not in ESG investing. Performance metrics for ESG investments and managers remain at best inconsistent. This is not necessarily the fault of data providers, but in the absence of an established framework, the race to market among vendors has only created

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more confusion and a paradox of choice among institutional investors. Understanding what's material requires transparency about the underlying assets as well as an understanding of how ESG risks and opportunities differ across markets and geography.

Meanwhile, at the fund manager level, there is ongoing debate around what constitutes an appropriate benchmark against which to gauge performance. When the larger benchmark providers — Russell, FTSE, MSCI, et al. — create more standardized benchmarks that are specific to sustainability strategies, it could really help with the evaluation process. However, they need to be widely accepted and more uniform, particularly for ERISA plans that could be subjected to potential lawsuits over performance. The good news, however, is that traction is being made on this front, including the recent collaboration among the framework organizations and even some consolidation among these groups (IIRC and SASB, being one example). Meanwhile, leading fund managers, consultants and asset owners have formed working groups under the United Nations' Race to Zero campaign to help foster alignment and facilitate transparency.

The shadow of a new round of regulatory interference also looms as an obstacle — for ESG has emerged as a political football. But when observers "zoom out" and consider how much the landscape has changed over a relatively short period — say 10 years or so — it seems clear that the ESG investing has reached a critical mass of mindshare. Progress in ESG investing seems inevitable, especially when a new generation leads the way and as the risks of ignoring ESG factors becomes more acute. If companies are pushing diversity, equity and inclusion ("DEI") and ESG on the company level, employees naturally ask, "Shouldn't they be thinking the same way for our retirement plan?"

Although the proposed rules reflect that the DOL is playing catchup to trends in less-restrictive investor circles, they represent essential progress. As it currently stands, the existing rules are too restrictive and effectively force plan sponsors to overlook non-financial factors that can indeed influence financial returns. With a new day for ESG investing just around the corner, more clarity is needed from the DOL for the defined contribution industry to embrace and codify the opportunity ahead.

Hannah Schriner is managing principal and consultant at **Meketa Investment Group**.

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