Twists and Turns on ESG Investing

By Tony Roda

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On May 20, President Joe Biden issued an Executive Order on Climate-Related Financial Risk (EO). The action signaled a fresh look at the complex intersection of sustainable investing, often referred to as Environmental, Social, and Governance, or ESG for short, and financial risk, specifically risk to physical assets, publicly traded securities, private investments, and companies, as well transition risk to workers, communities, and companies as the global shift from carbon-intensive energy sources and industrial processes accelerates.

In part, the EO states, "(t)he failure of financial institutions to appropriately and adequately account for and measure these physical and transition risks threatens the competitiveness of U.S. companies and markets, the life savings and pensions of U.S. workers and families, and the ability of U.S. financial institutions to serve communities." The EO instructs the Secretary of the Treasury, as the Chair of the Financial Stability Oversight Council (FSOC), to consider these risks to the financial stability of the federal government and the stability of the U.S. financial system. This is an approach that is similar to legislation introduced earlier this year by Senator Dianne Feinstein (D-CA), S. 588, which was endorsed by NCPERS.

An important part of the EO, Section 4, requires the Secretary of Labor to identify agency actions that can be taken under the Employee Retirement Income Security Act (ERISA) to protect the life savings and pensions of U.S. workers and families from the threats of climate-related financial risk and to consider publishing, by September 2021, for public notice and comment a proposed rule to suspend, revise, or rescind the Trump Administration's final rules on Financial Factors in Selecting Plan Investments and Fiduciary Duties Regarding Proxy Voting and Shareholder Rights. Earlier this year, the Biden Administration announced that it would not enforce either of these rules and would, instead, develop its own regulatory guidance on these policy questions. While state and local governmental plans are not governed by ERISA, policymakers and plan fiduciaries often look to the federal regulatory structure under ERISA as a guidepost for their decisions.

The Financial Factors in Selecting Plan Investments rule began as a proposed rule targeted specifically at ESG investments. It generated thousands of public comments, most of them calling the rule antiquated and potentially harmful to investors. The final rule, while stripped of its ESG-specific language, would still have resulted in a chill on these investments due to the onerous documentation requirements required to justify an investment that was not based solely on pecuniary factors.

Prior to the Trump DOL rule the guiding regulatory interpretation was that ESG factors could be used as a tiebreaker between or among otherwise indistinguishable investments. The philosophy of the Trump Administration in issuing the proposed and then the scaled-back final rule was that such a tie is rare or unlikely to ever occur. Therefore, under the Trump rule, in order to justify using non-pecuniary factors in reaching an investment decision the fiduciaries would have to document: (i) why pecuniary factors were not sufficient to select the investment; (ii) how the selected investment compares to alternative investments, including factors

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such as portfolio diversification, asset liquidity, cash flow, and projected return relative to plan funding objectives, and (iii) how the chosen non-pecuniary factors are consistent with the interests of participants and beneficiaries in their retirement income or financial benefits under the plan. This daunting documentation requirement would, in my view, have resulted in many plan fiduciaries avoiding ESG investments entirely.

Meanwhile in Congress, new legislation was recently introduced that is designed to end the regulatory see-saw on ESG investments that plan fiduciaries have endured for decades. The bill, S. 1762, was introduced by Senator Tina Smith (D-MN). Senator Patty Murray (D-WA), who chairs the Committee on Health, Education, Labor, and Pensions (HELP), is an original cosponsor of the legislation. Senator Smith also serves on the HELP Committee. The House version of the legislation, H.R. 3387, was introduced by Rep. Suzan DelBene (D-WA).

The legislation would amend ERISA, over which the HELP Committee has jurisdiction, to make clear that pension plans may consider ESG factors in their investment decisions when they are expected to have an impact on investment outcomes, provided fiduciaries consider such investments in a prudent manner consistent with their fiduciary obligations. The bill would also codify the tiebreaker rule and formally repeal the Trump Administration's fiduciary rule, both of which are discussed above.

In her press release, Sen. Smith states that, "According to the U.S. SIF's 2020 report on sustainable investing practices, sustainable investments grew by 42% among U.S. investors from 2019 to 2020 – now representing a third of all U.S. invested funds, or $17.2 trillion." The fresh look at the policy issues related to ESG investing, first by the Biden Administration and now by Congress, is a recognition that these types of investments are here to stay.

NCPERS will continue to keep you apprised of developments in this important public policy area. ◆

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