NEWSFLASH BRIEFING FOR PRIVATE FUNDS MANAGERS: ERISA VS ESG

The Department of Labor (DOL) has proposed a rule that will inhibit US private employer retirement plan investment in funds that promote the "non-pecuniary" benefits of the investment. Although the DOL did not precisely define what investments or funds would be the subject of this rule, the DOL referenced "socially responsible investing, sustainable and responsible investing, environmental, social and corporate governance (ESG) investing, impact investing, and economically targeted investing."[1]. For purposes of this discussion only, we refer to all investment strategies that may "promote non-pecuniary benefits or any other non-pecuniary goals" as "ESG." The DOL has not included an exact definition of ESG in its proposed rule.

Background

ERISA (the Employee Retirement Income Security Act of 1974) governs and regulates private-sector pension plans in the United States. ERISA imposes standards of care on the fiduciaries who manage ERISA plans, and those fiduciaries have to act "solely in the interest of the participants and beneficiaries and for the exclusive purpose of providing benefits to participants and their beneficiaries."

The DOL is concerned that the growing emphasis on ESG investing and the marketing efforts connected to ESG investment products is causing ERISA plan fiduciaries to make investment decisions for reasons other than what is best for growing the pensions that the fiduciaries steward (i.e., based on criteria other than direct financial performance).

Proposed New Rule

The proposed rule would require fiduciaries to follow rigorous documentation requirements when they select investment products for their pensions based on non-economic considerations. Fiduciaries would need to document in writing how

1 The DOL noted in the preamble to the proposed rule that these "terms do not have a uniform meaning and the terminology is evolving."

the investment product selected was appropriate based on accepted investment principles, confirming first that the product is otherwise economically no different from the investment alternatives otherwise available.

The DOL said that ESG factors promoted by a fund can actually be treated as "pecuniary factors" if the factors "present economic risks or opportunities that qualified investment professionals would treat as material economic considerations under generally accepted investment theories." The proposed rule, if finalized, could cause ERISA plan fiduciaries to avoid products that have been promoted as supporting an ESG imperative so as to avoid the need to later defend the investment with robust documentation of analysis.

Consultation / Next Steps for the Private Funds Industry

The Department of Labor will accept comments on the proposed rule until July 30, 2020.

Clarification of role of ESG vs specific "impact investing": Private fund sponsors and/or industry bodies may wish to seek confirmation from the DOL that an investment fund which describes in its marketing materials a commitment to environmental, social and/or governance-related objectives should not be within the scope of the new restriction, provided that the proposal being made to investors is focused on the economic features of the investment. We believe it is accepted in the market that a focus on ESG does not, in and of itself, amount to a disregard of economic returns (and indeed that healthy ESG practices often support and expand a portfolio company's financial performance). The DOL's proposed rule even acknowledges that ESG factors may be economic factors.

Role of Private Funds: It is arguable that the DOL's concerns about ESG funds should not be focused on the ERISA plans that invest in private funds. US pension plan investing obligations and strategies match nicely with the timing and expectations of many private funds. But in ERISA defined benefit pension plans, which have more than $3 trillion in assets, the employers or plan sponsors, not the participants, bear all the investment risks of the plans. If selected investments do not perform or are costly relative to alternative investments, participants get the same pension, because investment performance and selection is not connected to the value of the pensions being promised. It may be helpful to request that the DOL reflect this distinction in any final rule.

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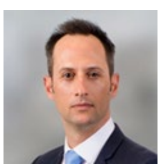

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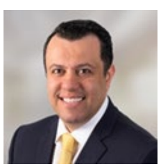

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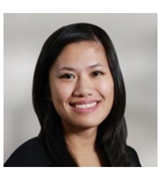

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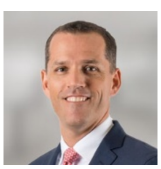

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