RETIREMENT SAVINGS, ESG INVESTING, AND EMPLOYER STOCK

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"ESG investing" is a relatively recent label for an older and broader practice: offering and choosing investment products based in part on the political or social behavior of the companies invested in. The ESG label refers to environmental, social, and governance criteria; an environmentally focused ESG fund, for example, might eschew investment in coal companies and favor investment in alternative power producers. Although ESG-type investment products have been around for decades, they appear to have gained popularity in recent years. By one measure, the amount invested in "sustainable funds" nearly quadrupled between 2018 and 2019.

Regardless of its merits generally, ESG investing makes for an uneasy fit in the world of employee pension plans. That uneasiness is deeply rooted in ERISA, the federal statute that governs private employers' plans, and it underlies a Trump-era regulation that the Biden Administration's Department of Labor (DOL) has put on hold pending a review. In the end, the new administration will probably only tinker with the regulation, rather than radically altering it. The same ERISA principles that counsel caution with respect to ESG investments, moreover, should lead the administration to examine critically a different category of plan investment decisions: those that involve stock in the company that sponsors the plan, referred to as "employer stock."

BACKGROUND

Depending on the type of pension plan involved, the people and entities—called "fiduciaries"—that run the plan may be directly responsible for investing the plan's assets, or they may be charged with choosing a menu of options in which participants may invest their own accounts. For decades, sub-regulatory guidance from the DOL has cast a dubious eye on fiduciaries' use of ESG-type investment criteria. The Trump regulation, finalized only eight days before President Biden's inauguration, continued that traditional skepticism but added some controversial new limitations.

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Both previous guidance and the new regulation emphasized that the central goal of fiduciaries' investment decisions must be to maximize the assets available for plan participants' retirement. In that context, both concluded, it would be inappropriate for a fiduciary to choose an investment based on ESG criteria if a comparable, non-ESG investment offered a higher expected return with the same level of risk, or the same expected return with less risk.

Under the earlier guidance, and at least in theory under the Trump regulation, fiduciaries were free to consider ESG factors that they reasonably believed were relevant to the investment's risks or expected returns. In the regulation's language, such relevant factors are "pecuniary," and factors not relevant to risks or returns are "non-pecuniary." Moreover, under both the guidance and the regulation, fiduciaries could consider even non-pecuniary ESG factors as a tiebreaker of sorts when choosing between investments with indistinguishable risk-return characteristics.

The Trump regulation, however, added some potentially onerous restrictions. First, the rule demanded meticulous documentation from fiduciaries who conclude they are in the "tiebreaker" situation or who judge that a specific ESG consideration is pecuniary. Second, the regulation flatly barred fiduciaries from including ESG investments in the default portfolios assigned to plan participants who have not made investment choices for their accounts. (The prohibition covers any investment whose objectives, goals, or strategies "include, consider, or indicate the use of one or more non-pecuniary factors.")

Throughout the regulation's path to adoption, investment providers and others worked, with only limited success, to oppose the new restrictions. In March 2021, however, the new administration's DOL announced that it would suspend enforcement of the regulation pending a fresh review. It seems reasonable to expect that, once its review is complete, the DOL might amend the regulation to soften or eliminate the most controversial parts, or it might try to blunt their effect through enforcement policy. But the DOL is unlikely to alter significantly the long-standing, cautious approach to ESG-type investing by plan fiduciaries. Nor should it.

ERISA AND ESG INVESTING

A guarded, even parsimonious, approach to ESG investing is a necessary implication of ERISA's provisions governing fiduciaries. Under ERISA, fiduciaries are required to act in the best interests of plan participants and their beneficiaries, with the exclusive purpose of providing benefits under the plan and defraying reasonable expenses. Those fiduciary duties apply to all the fiduciaries' plan-related decisions, including decisions about investing the plan's assets or choosing investments for participants to invest in.

Moreover, courts and the DOL have usually read ERISA's reference to "benefits under the plan" narrowly to mean only the benefits specifically promised under the plan. The term does not include advantages outside the plan, even if they flow to plan participants. A decision, for example, to use plan assets to resist a hostile takeover might preserve some participants' jobs. But those jobs are not benefits under the plan, so preserving them is unlikely to be a proper consideration in fiduciaries' decision making.

The statutory focus on providing plan benefits and covering plan expenses demands a skeptical approach to ESG investing. If ESG considerations materially affect an investment's risk or expected return, then a fiduciary should consider them along with other pecuniary factors. But fiduciaries should not choose ESG investments with less favorable risk-return profiles than comparable non-ESG options, because doing so would subordinate the plan's economic well-being to goals, such as environmental protection, that, however laudable, are extraneous to the statutorily mandated focus on plan benefits and expenses.

After its review, then, the Biden DOL will probably trim the rougher edges from the Trump regulation, but it will leave in place the traditional limits on fiduciaries' use of ESG-type investment criteria.

WHAT ABOUT EMPLOYER STOCK?

The DOL's attention to ERISA's "exclusive purpose" language as to ESG investing highlights a contradictory thread that runs through the statute and DOL policy. That thread allows, and even encourages, plans to include investments in employer stock, even though that practice is, to say the least, in tension with the exclusive purpose rule.

Fiduciaries of defined contribution pension plans, including 401(k) plans, are free to place employer stock among the investment options offered to participants, and the sponsors of such plans are free to provide matching contributions in employer stock. Indeed, an employer may even choose to sponsor a type of plan (called an ESOP) designed to invest more-or-less exclusively in employer stock.

Viewed ex-ante, it is a terrible idea to invest more than a small portion of one's retirement savings in the stock of one's employer. To do so flies in the face of undisputed insights about investment diversification, and it exposes retirement savings to the same employer-centered risks that unavoidably apply to a participant's wages and non-retirement benefits. A participant whose savings are invested heavily in employer stock risks catastrophic loss should the employer's fortunes decline; even without such a misfortune, the participant assumes unnecessary risk and volatility that diversified investments could avoid.

A fiduciary seeking to maximize benefits to plan participants, therefore, should not encourage, or perhaps even allow, participants to invest significant portions of their plan accounts in employer stock. And yet they do so, and both ERISA and the DOL's pronouncements enable that choice. That indulgence of employer-stock investment, moreover, is commonly justified using non-pecuniary considerations—that is, by invoking purported advantages that have nothing to do with the risks or expected returns of the investment.

Having employees own company stock through their retirement plans, those justifications say, gives them "skin in the game," increasing their connection to the employer and, ultimately, leading to greater productivity. Regardless of whether that productivity claim holds water empirically—and there are reasons to be dubious—it is emphatically not a claim that investing in employer stock is the best way to safeguard or maximize benefits under the plan. That is, it simply does not square with ERISA's demand that fiduciaries limit their purposes to providing plan benefits and defraying plan expenses.

That mismatch is, in part, a creature of the statute and is therefore Congress's to fix; exceptions to otherwise applicable ERISA rules authorize ESOPs and free other defined contribution plans to offer and promote employer stock as an investment. In some respects, then, the new administration would be limited to asking Congress for changes to the statute. But ERISA's basic fiduciary principles, including the "exclusive purpose" language, still apply to plans that include employer stock. The DOL could, at a minimum, require fiduciaries to explain, in detail, how their decisions regarding employer stock might satisfy the exclusive purpose rule.

Skepticism as to the prospect of legislative or regulatory change is warranted. Employers value the ability to offer employer stock and to make matching contributions in the form of such stock. A small but effective group of ESOP companies and service providers jealously guards the rules enabling that type of plan. And commentators, including me, have been pointing out the perils of employer-stock investments for a long time, with few policy results to show for it.

But indulging employer-stock investment in pension plans contradicts the same ERISA principles that are invoked to limit ESG investments. That contradiction should lead the Biden Administration to adopt a similarly skeptical approach to plan investments in employer stock.