It's Good for the Planet and It's Good for Your Portfolio: Encouraging Millennial Participation in 401(k) Plans Through Lowering Barriers To ESG Investing

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IT'S GOOD FOR THE PLANET AND IT'S GOOD FOR YOUR PORTFOLIO: ENCOURAGING MILLENNIAL PARTICIPATION IN 401(K) PLANS THROUGH LOWERING BARRIERS TO ESG INVESTING

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Investors are demanding greener and cleaner investment options. These values-based investors are increasingly pursing a strategy known as ESG, where a company's environmental, social, and governance decisions are included in the overall investment process. This strategy is especially popular among millennials, who are particularly concerned about climate change and other social justice issues. In a recent survey, 90% of millennials stated they would be interested in an ESG option in their 401(k) retirement plan lineup. Yet, only 3% of employers offer one.

Employers' reticence to offer an ESG option is understandable in light of Department of Labor regulations that suggest doing so might violate the strict fiduciary requirements under the federal law regulating employee benefit plans (known as ERISA.) The Department of Labor justified this regulation by suggesting that ESG is a suspect strategy that values a positive impact on the planet over maximizing financial returns. But long-term research into ESG investing shows this concern is unwarranted—ESG investments perform as well, and sometimes better than, non-ESG investments, which makes sense when you understand the ESG strategy to be simply another layer of investment analysis and risk management.

ESG investing does not violate any of ERISA's fiduciary requirements. To the contrary, ESG investing offers values-based investors the rare win-win—it is good for the planet, and it is good for their retirement portfolio. The Department of Labor should re-write the ESG regulations accordingly to encourage more employers to offer an ESG option. In turn, offering an ESG option may encourage more millennials to participate in their 401(k)s, saving more for retirement while also providing a market incentive for companies to get greener. An ESG investment option in a 401(k) plan lineup would be good for a portfolio and good for the planet.

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INTRODUCTION

Imagine the stereotypical millennial—what comes to mind? Do you think of avocado toast?[2] Side parts and skinny jeans?[3] Maybe you think of the recent runup of GameStop and the increasing popularity of millennial investing websites like Robinhood,[4] or the millennial (and Gen-Z) dominated protests for climate change[5] and racial equity.[6]

Stereotypes aside, one of the defining features of the millennial generation is its focus on corporate values and sustainability. 71% report feeling their lives are immediately threatened by climate change.[7] 70% of millennials actively consider a company's values when making a purchase, as compared with 52% of all adults.[8] 90% say they want to tailor their investments to their values.[9]

Millennials' focus on sustainability and values-based investing is no surprise, given the increasing threat of climate change that looms over this generation. But many millennials, and Americans in general, do not have access to a sustainable investment option that might accord with their values. For more than 20% of Americans, their only form of investment vehicle is their 401(k),[10] and only 3% of employers offer a sustainable investment option in their 401(k) lineup.[11] It is possible that encouraging more employers to offer sustainable investment options

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[2] Sam Levin, *Millionaire Tells Millennials: If you Want a House, Stop Buying Avocado Toast*, THE GUARDIAN (May 15, 2017), https://www.theguardian.com/lifeandstyle/2017/may/15/australian-millionaire-millennials-avocado-toast-house.

[3] Erica Tempesta, *Millennials Go to War with Gen Z Over Skinny Jeans and Side Parts*, THE DAILY MAIL (Feb. 5, 2021), https://www.msn.com/en-us/lifestyle/lifestyle-buzz/millennials-go-to-war-with-gen-z-over-skinny-jeans-and-side-parts/ar-BB1dr8l3.

[4] Miles Brignall, *How GameStop Traders Fired the First Shot in Millennials' War on Wall Street*, THE GUARDIAN (Jan. 30, 2021), https://www.theguardian.com/business/2021/jan/30/how-gamestop-traders-fired-the-first-shots-in-millenials-war-on-wall-street; Dave Fogel, *Millennials and the Robinhood Revolution*, American Bar Ass'n: After the Bar, https://www.americanbar.org/groups/young_lawyers/publications/after-the-bar/student-loans-and-finances/millennials-robinhood-revolution/.

[5] Matthew Ballew, Jennifer Marlon, et al, *Young Adults, Across Party Lines, Are More Willing to Take Climate Action*, YALE PROGRAM ON CLIMATE CHANGE COMMUNICATION (April 28, 2020), https://climatecommunication.yale.edu/publications/young-adults-climate-activism/.

[6] Ruth Milkman, *A New Political Generation: Millennials and the Post-2008 Wave of Protest*, 82(1) AM. SOCIOLOGICAL R. 1, 1 (2017), https://journals.sagepub.com/doi/pdf/10.1177/0003122416681031.

[7] *Climate Change Will Still Matter to Gen Z & Millennials—Here's How We Know*, YPULSE (April 22, 2020), https://www.ypulse.com/article/2020/04/22/climate-change-will-still-matter-to-gen-z-millennials-heres-how-we-know/.

[8] Anjali Lai, *Millennials Call for Values-Driven Companies, But They're Not the Only Ones Interested*, FORBES (May 23, 2018), https://www.forbes.com/sites/forrester/2018/05/23/millennials-call-for-values-driven-companies-but-theyre-not-the-only-ones-interested/?sh=1a6d0d7d5464.

[9] MSCI, SWIPE TO INVEST: THE STORY BEHIND MILLENNIALS AND ESG INVESTING 1 (March 2020), https://www.msci.com/documents/10199/07e7a7d3-59c3-4d0b-b0b5-029e8fd3974b#:~:text=%E2%80%9CDemand%20for%20sustainable%20investments%20is,management%20clients%20at%20Ernst%20%26%20Young.

[10] GARY MOTTOLA, A SNAPSHOT OF INVESTOR HOUSEHOLDS IN AMERICA, FINRA INVESTOR EDUCATION FOUNDATION (Sept. 2015), available at https://www.sec.gov/spotlight/fixed-income-advisory-committee/finra-investor-education-foundation-investor-households-fimsa-040918.pdf.

[11] Greg Iacurci, *Climate Funds Hold Less than 1% of 401(k) Money. Here's Why,* CNBC (Dec. 14, 2020), https://www.cnbc.com/2020/12/11/heres-why-401k-plans-lag-in-green-investment-options.html.

in their 401(k) lineups could encourage more millennials, who are vastly under saving for retirement,[12] to participate more and contribute in greater amounts to their 401(k)s.

Millennials are not the only group interested in sustainable investing. A sustainable investment strategy known as "ESG investing" is popular across all generations. Individual and institutional investors are increasingly promoting ESG investing. This strategy involves identifying companies that have a positive impact on the planet (using certain environmental, social, and governance, or "ESG", factors) and then directing assets towards those companies, either through purchasing individual stocks or bonds, or through building and buying ESG-friendly funds.[13]

Currently, a third of all U.S. professionally managed assets are held in funds using some form of ESG investing strategy, to the tune of $17 trillion dollars.[14] And over $1.7 trillion are invested directly in ESG funds[15] (not all funds using ESG strategies self-identify as an "ESG fund.")[16] But these dollars invested in ESG funds are overwhelming in taxable accounts, and are almost exclusively *not* in retirement accounts. In fact, less than 0.1% of total 401(k) assets (less than $9 billion) are invested in ESG funds.[17] ESG is vastly underrepresented in 401(k) plans.

The discrepancy between taxable assets invested in funds using ESG investing strategies and employer-sponsored retirement assets invested in ESG-type funds is because of a lack of ESG-friendly 401(k) investment options. Fewer than 3% of employers offer an ESG investment in their 401(k) lineup.[18] The dearth of ESG in 401(k) plans makes it harder for employees to access ESG and likely makes 401(k) plans less desirable savings vehicles for values-based investors, such as many millennials. This lack of ESG access for retirement plan investors is due to the Trump-era Department of Labor's strict regulation of retirement plan fiduciaries, and the current regulatory framework around what type of investments are allowed in employer-sponsored, participant-direct retirement plans.

A Trump Administration U.S Department of Labor regulation[19] entitled "Financial Factors for Selecting Plan Investments," —also known as the ESG Rule[20]— increases the burden upfront for retirement plan providers who want to offer an ESG option in their lineup by

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[12] *Employment Alert: Young Workers Face Hard Times in Retirement*, 1 EMP. ALERT 11, 28 (Jan. 14, 2011), available at https://www.westlaw.com/Document/I873fa4701d7c11e08b05fdf15589d8e8/View/FullText.html?transitionType=Default&contextData=(sc.Default)&VR=3.0&RS=cblt1.0 (finding that millennials are at the highest risk of retirement insecurity compared to older generations, and predicting that eight out of ten millennials will not be able to meet their financial needs in retirement without significant changes in their saving and investing behaviors.)

[13] Alana Benson, *ESG Investing: A Beginner's* Guide, NERDWALLET (April 6, 20201), https://www.nerdwallet.com/article/investing/esg-investing.

[14] PARNASSUS INVESTMENTS, REPORT ON US SUSTAINABLE AND IMPACT INVESTING TRENDS 1 (2020), https://www.ussif.org/files/Trends%20Report%202020%20Executive%20Summary.pdf.

[15] Simon Jessop & Elizabeth Howcroft, *Sustainable Fund Assets hit Record $1.7 Trillion in 2020: Morningstar,* REUTERS (Jan. 28, 2021), https://www.reuters.com/article/us-global-funds-sustainable/sustainable-fund-assets-hit-record-1-7-trln-in-2020-morningstar-idUSKBN29X2NM.

[16] Sophie Baker, *Global ESG-data Driven Assets Hit $40.5 trillion,* PENSIONS & INVESTMENTS (July 2, 2020), https://www.pionline.com/esg/global-esg-data-driven-assets-hit-405-trillion.

[17] Greg Iacurci, *Climate Funds Hold Less than 1% of 401(k) Money. Here's Why,* CNBC (Dec. 14, 2020), https://www.cnbc.com/2020/12/11/heres-why-401k-plans-lag-in-green-investment-options.html.

[18] *Id.*

[19] Financial Factors in Selecting Plan Investments, 29 C.F.R. 2509, available at https://www.federalregister.gov/documents/2020/11/13/2020-24515/financial-factors-in-selecting-plan-investments.

[20] Maureen J. Gorman & Debra B. Hoffman, *The Department of Labor's ESG-less Final ESG* Rule, MAYER BROWN: BENEFITS & COMPENSATION BLOG (Nov. 11, 2020), https://www.usbenefits.law/2020/11/the-dol-final-esg-rule/

requiring them to excessively document the process and rationale upfront for selecting a fund relying on "non pecuniary" factors, such as ESG. The Labor Department justified this strict regulation of ESG investing by centering it within the narrow focus that the Employee Retirement Income Security Act of 1974 (ERISA) takes towards ensuring retirement security. To ensure that workers' retirement savings are adequately managed, ERISA sets out strict fiduciary duties of loyalty solely to the plan beneficiaries and prudence as to the process of selecting and monitoring fiscally responsible investment options.[21] But ruling out ESG funds for fiduciary reasons is flawed for (at least) two reasons.

First, this justification sets up a false dichotomy between good financial returns and ESG factors. It fails to recognize that employers and their fiduciaries can increase retirement saving *through* allowing values-based investing. A well-selected ESG investment option has as much of a chance of providing positive returns as a well-selected non ESG investment option.[22] It is neither disloyal to the plan participant nor fiscally imprudent to offer a well-managed and thoughtfully constructed ESG investment option that will both provide excellent returns for the beneficiary and have a positive impact on global sustainability.

Second, this justification takes too narrow of a look at how fiduciaries can facilitate retirement security for employees. It is insufficient to focus solely on risk/return of plan participants without also encouraging employees to opt into the plan in the first place. If millennials are choosing not to invest in their retirement plan, but are using apps like Robinhood to direct values-based investments using other discretionary funds,[23] fiduciaries can entice these values-based millennial investors to continue to invest in sustainable business, but with tax-advantaged retirement savings and an employer match instead.[24]

ESG investing is particularly attractive to millennials, a generation that has been hard hit both by increased climate change and increased retirement insecurity.[25] According to recent surveys, millennial investors are twice as likely as the general investor population to invest in companies with ESG related goals.[26] 90% of millennial investors stated they want an ESG option in their 401(k) plan.[27] Many of these values-driven millennials are also not adequately saving for retirement, and at least a small portion of them are under saving in their 401(k)s because they are

[21] https://www.federalregister.gov/d/2020-24515/p-36.

[22] Madison Sargis & Patrick Wang, *How Does Investing in ESG Companies Affect Returns,* MORNINGSTAR (Feb. 19, 2020), https://www.morningstar.com/insights/2020/02/19/esg-companies

[23] Dave Fogel, *Millennials and the Robinhood Revolution*, AMERICAN BAR ASS'N: AFTER THE BAR, https://www.americanbar.org/groups/young_lawyers/publications/after-the-bar/student-loans-and-finances/millennials-robinhood-revolution/.

[24] *The Tax Benefits of Your 401(k) Plan,* TURBOTAX, (2020), https://turbotax.intuit.com/tax-tips/investments-and-taxes/the-tax-benefits-of-your-401k-plan/L8QHCzbiO.

[25] THE DELOITTE GLOBAL MILLENNIAL SURVEY 2020 3, 7, 9-11 (2020), available at https://www2.deloitte.com/global/en/pages/about-deloitte/articles/millennialsurvey.html; Audrey Choi, *How Younger Investors Could Reshape the World,* MORGAN STANLEY: WEALTH MANAGEMENT (Jan. 24, 2018), https://www.morganstanley.com/access/why-millennial-investors-are-different ("In 2012, 31 percent of millennials participated in an employer-sponsored program, whether a defined benefit plan such as a pension or a defined contribution plan such as a 401(k).4 About half of Gen Xers participated in a plan that year, while 56 percent of baby boomers took part in one. Though traditional pensions were once the more typical way to build retirement income, participation rates for defined benefit plans varied in a relatively narrow range, rising from 6 percent for millennials to 13 percent for boomers. Participation rates in defined contribution plans rose more dramatically by generation, from 25 percent for millennials to 40 percent for Gen Xers and 43 percent for boomers.")

[26] *Id.*

[27] *Id.*

saving in other types of investment vehicles.[28] Providing a greener and cleaner ESG option in their tax-advantaged retirement plans could redirect millennial investment dollars into 401(k)s, encouraging millennials to save more towards retirement and facilitating ERISA's overall goal of ensuring retirement security for American workers.

This article argues that, if new regulations lower the burden of offering an ESG option in a retirement plan lineup, retirement investors, particularly millennials, would likely redirect some or all of their retirement plan assets towards a sustainable investment option. This would not only be good for the planet, since it would direct more dollars towards companies with a sustainable footprint and incentivize other companies to get on board, but would be good for millennial retirement plan participants. Giving those investors a greener, cleaner retirement plan option aligned to their millennial values might prompt more millennials and other values-driven retirement plan investors to participate in greater numbers and invest in higher amounts in their retirement plans. Given the power of compound interest, even a marginal change in millennial participation in 401(k) plans as a result of increased access to ESG investing would have an outsized impact on their economic stability in retirement.

While the 2021 Department of Labor recently announced a nonenforcement policy of the ESG Rule, a simple non enforcement of this rule does not go far enough to encourage plan fiduciaries to offer an ESG investment in their lineup. The Biden Administration should go further and issue a new ESG Rule that actively encourages plan fiduciaries to offer a fiscally responsible ESG fund in their lineup to encourage more millennial and other values-based investor participation and contribution to their retirement savings.

It is important to note that this article does not pretend to offer an easy Labor Department regulatory fix to all of the millennial generation's economic hardships. ESG investing will not somehow magically cure millennials of a debt crisis caused by ballooning costs of higher education and a depressed job market post Great Recession and the COVID-19 pandemic. But marginal retirement investing at a young age has enormous returns, thanks to compound interest. And this regulatory change is a cheap and easy way to encourage a *bit* more saving, while also increasing investment in sustainable businesses and encouraging companies to care about climate change.

Plenty has been written about ERISA's regulation of plan investments, and in the past few years there have been strong pieces of scholarship on the role the Labor Department should play in regulating ESG in ERISA-regulated lineups.[29] This article adds to the body of scholarship in two ways. First, it argues that ERISA and the Labor Department should actively encourage ESG investing, and that intelligent and modern approaches to ESG investing do not run afoul of ERISA's duties of loyalty and prudence. Second, this article novelly suggests that lowering the burden, or even encouraging, fiduciaries to include ESG investment options in their plan lineup might encourage more retirement savings in general.

This article will proceed in four parts. Part I will provide background on ESG—the history of values-based investing, changing approaches to ESG investing, and increased individual and institutional investor appetite for ESG investment options.

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[28] *Generational Retirement Trends Study*, T. ROWE PRICE (2015), at slide 12, available at https://www.slideshare.net/TRowePrice/generational-retirement-trends-study-2015/12-1212By_Worker_GenerationMajor_Reasons_for.

[29] *See generally* Bernard Sharfman, *ESG Investing Under ERISA*, 38 YALE J. REG. BULLETIN 112 (2020); Max M. Schanzenbach & Robert H. Sitkoff, *Reconciling Fiduciary Duty and Social Conscience: The Law and Economics of ESG Investing by a Trustee*, 72 STANFORD L. REV. 381 (2020); Susan N. Gary, *Best Interests in the Long Term: Fiduciary Duties and ESG Integration*, 90 U. COLORADO L. REV. 731 (2019).

Part II will dive into the marginal positive impacts that opening up access to retirement plan investing in ESG could have on retirement saving in general. This section will discuss the general retirement savings crisis in the United States, and the particular hurdles the millennial generation faces with retirement saving. This section will posit that allowing employees to invest their retirement savings into ESG funds could, on the margin, increase retirement savings, which for young employees could have a large financial impact thanks to compound interest.

Part III will examine the relationship between ERISA, the Department of Labor, and ESG investing. This Part will discuss how ESG investing fits into ERISA's regulation of fiduciaries, and suggest how fiduciaries could include ESG options in their lineups without running afoul of their fiduciary duties.

Finally, Part IV will lay out recommendations to the incoming Biden Administration for how they can revise the Financial Factors rule to lower the burden, or even encourage, ERISA-regulated fiduciaries to include an ESG option in their retirement plan investment lineup.

I. A HISTORY OF ESG

A. *Defining ESG*

What is colloquially referred to today as "ESG investing" has a number of different names. Some people refer to this type of investing as values-based investing, or responsible investing, or sustainable investing. In the past it was referred to as "socially responsible investing." These different names all have the same core strategy—to consider facts that traditionally were not part of a classic financial analysis process, yet have broader relevance to the impact of a company on the environment. Many investors believe, and many studies have shown, that while these factors may not have been traditionally considered as part of the investment valuation process, they have significant financial relevance to the performance of the company. They may include how companies are responding to climate change, the size of their "carbon footprint", how their health and safety policies work to protect their employees, how they treat workers more generally, or whether their corporate culture builds trust and spurs innovation.[30]

While evidence of values-based investing can be traced back as early as the 1700s,[31] this type of investing strategy took hold in the United States in the 1970s and 1980s in response to the Vietnam War and apartheid in South Africa. Back then, this type of values-based investing was coined "socially responsible investing", or SRI.[32] Activists called for boycotts and

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[30] E. Napoletano & Benjamin Curry, *Environmental, Social and Governance: What is ESG Investing?,* FORBES: ADVISOR (Mar. 1, 2021), https://www.forbes.com/sites/georgkell/2018/07/11/the-remarkable-rise-of-esg/?sh=19865b3d1695.

[31] The founder of the Methodist Church, John Wesley, warned his followers not to profit off of harmful business practices, such as alcohol, the slave trade, and the production of dangerous chemicals. Max Schanzenbach & Robert H. Sitkoff, *Reconciling Fiduciary Duty and Social Conscience: The Law and Economics of ESG Investing by a Trustee*, 72 STAN. L. REV. 381, 392 (2020).

[32] E. Napoletano & Benjamin Curry, *Environmental, Social and Governance: What is ESG Investing?,* FORBES: ADVISOR (Mar. 1, 2021), https://www.forbes.com/sites/georgkell/2018/07/11/the-remarkable-rise-of-esg/?sh=19865b3d1695.

divestment from companies doing business in South Africa, or from companies who did not promise to abide by certain nondiscrimination principles in their South African operations.[33]

Values-based investment strategies and marketing has shifted since the 1970s. In addition to incorporating a company's environmental and social impact into the valuation process, modern ESG investors also incorporate corporate governance structure into their investment strategies (the "G" in ESG.) In addition, these values-based funds now seek to allure investors through the superior investment returns, in addition to their ethical benefits, as the funds may have less exposure to long-term risks by avoiding certain ESG red flags.[34]

The modern term "ESG" was first used in a 2005 research study titled, 'Who Cares Wins,"[35] authored by twenty financial institutions from nine countries with total assets under managements of over $6 trillion.[36] The report argued there was a direct connection between the way companies manage their environmental, social, and corporate governance issues and their overall management qualities.[37] In addition, the report argued that companies with high E, S, and G performance increase shareholder value, by "properly managing risks, anticipating regulatory action or accessing new markets, while at the same time contributing to the sustainable development of the societies in which they operate. Moreover, these issues can have a strong impact on reputation and brands, an increasingly important part of company value."[38] The report recommended that investment analysts and financial institutions incorporate ESG factors into their research and investment processes to help better value companies and contribute towards more stable and sustainable financial markets.[39]

B. ESG Investing

Individuals today have many different opportunities to invest in ESG. Research firms evaluate companies for their corporate governance structure and their environmental and social impact and give an ESG or green designation to companies meeting certain requirements. Additionally, investment companies offer ESG funds that invest in ESG-friendly companies, and individuals can buy into these funds just as they can buy into a mutual fund or exchange-traded fund (ETF).[40] Individuals can either invest directly in ESG-friendly companies or in ESG-friendly investment vehicles like a mutual fund or an ETF.[41] They can invest their discretionary dollars in a taxable brokerage account, through brokers such as Fidelity or Robinhood, or they can allocate portions of a retirement account, like an IRA, towards those companies or funds. In theory, if an employer provided an ESG option, employees could also direct their 401(k) dollars into an ESG fund, much as employees can currently direct those funds into a suite of non-ESG investment options.

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[33] Max Schanzenbach & Robert H. Sitkoff, *Reconciling Fiduciary Duty and Social Conscience: The Law and Economics of ESG Investing by a Trustee*, 72 STAN. L. REV. 381, 392 (2020).
[34] *Id.*
[35] UNITED NATIONS GLOBAL COMPACT, WHO CARES WINS (2004), available at https://d306pr3pise04h.cloudfront.net/docs/issues_doc%2FFinancial_markets%2Fwho_cares_who_wins.pdf.
[36] *Id.* at i.
[37] *Id.*
[38] *Id.*
[39] *Id.* at ii, v
[40] Jeff Reeves, *7 Socially Responsible ETFs to Buy Now*, U.S. NEWS (June 17, 2020), https://money.usnews.com/investing/funds/slideshows/socially-responsible-etfs-to-buy-now.
[41] Debbie Carlson, *How to Invest In Green Stocks*, U.S. NEWS (May 28, 2020), https://money.usnews.com/investing/investing-101/articles/how-to-invest-in-green-stocks.

ESG funds and ESG managers use different types of portfolio construction tools and strategies to build fiscally and socially responsible investment products. Except for passive ESG indexes (discussed below), most ESG funds are actively-managed funds that use ESG information as a part of their investment strategy. All actively managed funds use a specific strategy in their attempt to "beat the index," or product risk-adjusted returns.[42] Some of those strategies might include being overweight in growth sectors or looking for a specific amount of leverage or debt to capital ratio. Active ESG funds use ESG metrics to attempt to come to a deeper understanding of a company's value and beat a benchmark to produce outsized returns. Recent research by JP Morgan Chase concluded there is a significant value-add to considering ESG factors as part of active portfolio management and demonstrates "that the boost in alpha [returns] arises from ESG's risk mitigant nature…[and] carr[ies] significantly lower credit risk relative to the 'Pure Value' [non ESG] strategy."[43]

A group of financial industry leaders working with the Investment Company Institute classified three different methods of ESG investing.[44] The first method of ESG investing is "ESG exclusionary," which is the most similar to the passive screening tactics used in the past.[45] These types of funds simply eliminate companies based on a specific value. For example, Nuveen's ESG Mid-Cap Growth ETF is a broad asset allocation fund that screens out fossil fuel companies, while still maintaining traditional broad market exposure.[46] Another example of an ESG friendly ETF that maintains broad exposure while screening out fossil fuels is State Street's SPDR S&P 500 Fossil Fuel Free ETF, which mimics the S&P 500 but screens out fossil fuel companies.[47] Similar ESG funds and indexes exist where the manager just screens out tobacco companies.[48]

Funds using ESG exclusionary strategies can be active or passive funds—fund managers can choose either to simply mimic an existing index, but exclude certain companies for "bad" ESG practices,[49] or funds can be actively managed using a proprietary investment strategies, yet refuse to include certain companies with "bad" ESG practices.

The second and third type of ESG investing, called "ESG inclusionary" and "impact investing," both take an active investment approach.[50] Morningstar, a highly regarded independent investment research company, described this active approach to ESG investing as

[42] *Active Management*, CORPORATE FINANCIAL INSTITUTE, https://corporatefinanceinstitute.com/resources/knowledge/trading-investing/active-management/.

[43] SHIVAM GHOSH, J.P. MORGAN CHASE & CO., VIRTUE ISN'T THE ONLY REWARD 1 (15 March 2020). On file with the author, Courtesy J.P. Morgan Chase & Co., Copyright 2021.

[44] INVESTMENT COMPANY INSTITUTE, FUNDS USE OF ESG INTEGRATION AND SUSTAINABLE INVESTING STRATEGIES: AN INTRODUCTION 3 (2020), https://www.ici.org/pdf/20_ppr_esg_integration.pdf.

[45] *Id.* at 5

[46] Lara Crigger, *Dirtiest & Cleanest ESG Funds*, ETF.COM (June 30, 2020), https://www.etf.com/sections/features-and-news/dirtiest-cleanest-esg-funds?nopaging=1

[47] Max Chen, *Investors are Re-Evaluating the Future of Fossil Fuel, Energy*, ETF TRENDS: ESG CHANNEL (Dec. 11, 2020), https://www.etftrends.com/esg-channel/investors-are-re-evaluating-the-future-of-fossil-fuel-energy/.

[48] Joe McGrath, *MSCI Launches Tobacco Exclusion Indexes*, ESG CLARITY (Sept. 27, 2018), https://esgclarity.com/msci-launches-tobacco-exclusion-indexes/.

[49] Dana Brakman Reiser & Anne Tucker, *Buyer Beware: Variation and Opacity in ESG and ESG Index Funds*, 41 CARDOZO L. REV. 1921, 1935-1938.

[50] INVESTMENT COMPANY INSTITUTE, FUNDS USE OF ESG INTEGRATION AND SUSTAINABLE INVESTING STRATEGIES: AN INTRODUCTION 6-7 (2020), https://www.ici.org/pdf/20_ppr_esg_integration.pdf.

a risk-management process, as companies that embrace sustainable practices are managing liabilities better than others, perhaps recognizing new opportunities, and may be better positioned to grow in the future. Environmental, social, and governance investing has evolved from funds that simply screened out undesirable companies like polluters or sellers of tobacco to strategies that apply a matrix of sophisticated screens to assess the best and worst players in every industry and actively seek to have a positive impact in many ways.[51]

Both ESG inclusionary and impact investing strategies use ESG information to select which companies to include in a portfolio. A portfolio using an ESG inclusionary strategy might diversify its holding across sectors and choose to include companies with higher relative ESG scores as compared to peer companies in that same industry. A fund using the impact investing strategy would have its investment analysts pick high quality companies with high ESG scores in a specific value of interest, to build a "green" fund or a "gender diversity" fund. Both of these strategies use active investing rather than passive screening, as analysts are actively reviewing and investigating a company's overall structure and value, and include high quality companies that also score well on the specific desired ESG metric. This is different from a passive screening strategy, where a fund will simply mimic another fund or index, but screen out "bad" ESG companies.

One example of an ESG investment advisor that uses active asset management research to pick companies that are predicted to perform well overall *and* have a positive ESG global impact is the newly launched Humankind Investments. This investment advisor has an actively managed ESG ETF that, like many of the other actively managed ESG funds, uses the same sort of valuation tactics as other non-ESG funds, but simply weighs the ESG classifications higher than a non ESG fund might otherwise.

Humankind's analysts use a variety of factors, including ESG and traditional financial metrics, to calculate a Humankind Value score, and invests in companies with high scores on this metric. The founder, James Katz, explained the logic behind the process as reflective of his belief "that traditional investment analysis, with its typically narrow focus on standalone financial performance, fails to fully capture a company's ability to remain sustainable and competitive in the long run."[52] Humankind acknowledges they are not looking only to invest in companies that are perfect on all possible ESG factors and that they are just looking to include companies that add more positive impact on the world than negative.[53] This approach of looking at the overall ESG picture and the company's overall ESG global impact is a strategy that is common across active ESG investors.

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[51] Russel Kinnel, *How Vanguard, Fidelity, and Others Embrace ESG Investing,* MORNINGSTAR (Jun. 2, 2020), https://www.morningstar.com/articles/986785/how-vanguard-fidelity-and-others-embrace-esg-investing.

[52] Baley McCann, *Former Vanguard Analyst James Katz Launched Humankind Investments in 2019, and its ESG Etf Will Track a Proprietary 'Equity Index'*, CITY WIRE (Feb. 24, 2021), https://citywireusa.com/professional-buyer/news/former-vanguard-analysts-firm-launches-its-first-esg-etf/a1471387.

[53] *Positive Impact Doesn't Require Perfection,* HUMANKIND INVESTMENTS, https://www.humankind.co/article?__hstc=246760475.03ac9d2db8fdaac5096f8982b29c438b.1614198786313.1614198786313.1614198786313.1&__hssc=246760475.1.1614198786314&__hsfp=1895085607#3Cf2oVL59Ag0CbVTqHe7wx, last accessed April 16, 2021.

C. ESG Performance

A persistent, but untrue, stereotype about ESG investing that has likely contributed to the Labor Department's strict regulation on ESG investing, is that ESG investments have poor returns compared to non-ESG investments.[54] This claim may come from outdated understandings of what ESG investing looks like (pure screening mechanism versus an active process as detailed above) or from a political agenda seeking to discourage investment in sustainable or green businesses. No matter its generation or motivation, broad brushing ESG investing as irresponsible investing is simply untrue.

Scores of studies and years of research have shown no increased risk in investing in ESG versus traditional non-ESG funds, and, in fact, some recent studies and interviews with investment analysts have suggested there is *less* risk in investing in ESG versus non ESG funds. A 2020 Morningstar study showed there was no greater investment risk to investing in ESG, rather than non-ESG, on a global level.[55] A 2019 study found that a high ESG portfolio outperformed a comparable low ESG portfolio by 16 basis points per year.[56] A 2015 study examined over 2,000 studies of ESG performance and found that, in 90% of the studies, there was no negative relationship between concern for social factors and corporate financial performance.[57] And, a large majority of the studies found a stable and positive relationship between ESG factors and corporate financial performance.[58] This positive correlation between ESG scores and financial performance makes sense—the factors underlying high ESG ratings also help to drive value, by lowering risks of worker safety incidents, pollution spills, litigation, and other public relations disasters that can damage a company's brand and valuation.[59]

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[54] Susan N. Gary, *Best Interests in the Long Term: Fiduciary Duties and ESG Integration,* 90 U. COLORADO L. REV. 731, n. 7 ("See, e.g., Jon Hale, Does Sustainable Investing Help or Hurt Returns?, MORNINGSTAR (Dec. 7, 2017), http://news.morningstar.com/articlenet/article.aspx?id=839607 [https://perma.cc/F5JL-RRMH] (describing the continuing "misimpression" that sustainable investing will hurt returns). A 2015 study found that "misperceptions of negative impact of investment performance" was considered a major challenge by 60 percent of respondents and a moderate challenge by 28 percent. ROBERT G. ECCLES & MIRTHA D. KASTRAPELI, THE INVESTING ENLIGHTENMENT: HOW PRINCIPLE AND PRAGMATISM CAN CREATE SUSTAINABLE VALUE THROUGH ESG (2017) (quoting UNPRI & CERULLI ASSOCIATES, Evolving Product Trends: Strategic Beta and ESG/SRI, U.S. PROD. & STRATEGIES 2016, 80 (2016)), http://www.statestreet.com/content/dam/statestreet/documents/Articles/The_Investing_Enlightenment.pdf [https://perma.cc/GB53-ZM8H].

[55] Madison Sargis & Patrick Wang, *How Does Investing in ESG Companies Affect Returns,* MORNINGSTAR (Feb. 19, 2020), https://www.morningstar.com/insights/2020/02/19/esg-companies.

[56] Guatum Dhingra & Christopher J. Olson, *ESG Investing: Can You Have Your Cake and Eat it Too?* CFA Institute, (Sept. 3, 2019), https://blogs.cfainstitute.org/investor/2019/09/03/esg-investing-can-you-have-your-cake-and-eat-it-too/.

[57] Gunnar Friede et al, *ESG and Financial Performance: Aggregated Evidence from More than 2000 Empirical Studies,* 5. J. Sustainable Finance & Investment 210, https://www.tandfonline.com/doi/full/10.1080/20430795.2015.1118917.

[58] *Id.*

[59] SARA BERNOW ET AL, MCKINSEY & COMPANY, FROM 'WHY' TO 'WHY NOT': SUSTAINABLE INVESTING AS THE NEW NORMAL 3 (Oct. 2017), https://www.mckinsey.com/~/media/McKinsey/Industries/Private%20Equity%20and%20Principal%20Investors/Our%20Insights/From%20why%20to%20why%20not%20Sustainable%20investing%20as%20the%20new%20normal/From-why-to-why-not-Sustainable-investing-as-the-new-normal.ashx.

Incorporating ESG analysis is now considered by the financial industry to be an important part of responsible portfolio construction.[60] A recent research report from J.P. Morgan Chase tested this theory, tracking the performance of funds constrained to only the "top rated ESG issuers," and found this type of ESG constraint "not only improves the ESG profile of a portfolio but also boosts alpha [return]."[61] The report concluded that "for an active manager following a Value-like strategy, ESG constraints can increase returns and improve risk adjusted performance."[62]

Unsurprisingly, many actively managed ESG funds outperform other types of actively managed funds. This outperformance makes sense when you understand the value-add of ESG factor analysis to an analyst's understanding of a company's ESG-related risk exposure. For example, Vanguard's FTSE Social Index Fund saw outsized returns over one year (18.3%,) three years (10%,) and five years (14.4%.)[63] This performance beat out 98% of non-ESG funds holding stock in large companies with similar growth and value characteristics.[64]

The anti-ESG advocates arguing that it is fiscally irresponsible to invest retirement plan assets in ESG funds are out-of-step with what the financial industry has determined is the best step for increased returns.

As mentioned above, one reason why this negative, yet untrue, perception of ESG investing continues to circulate even in highly educated circles is because of an outdated understanding of what ESG investing entails. Critics point to some ESG investors' tendencies to screen out companies based on non-ESG friendly factors, such as companies that issue dual-class shares (a "no no" for ESG investors particularly concerned about governance issues.) Bernard S. Sharfman recently made the claim in the Yale Journal on Regulation Bulletin that ESG investing is irresponsible because it screens out companies with bad "G" ratings, like Alphabet or Zoom, making the fund inherently underperform the broader market. [65] The argument is that, if ESG funds are excluding companies with dual-class shares, they are inherently screening out some of the most successful and high performing equities from companies like Alphabet, Zoom, and Facebook, all of which issue multiple classes of shares.

This way of describing ESG investing is misleading for many reasons, mostly because it mis-characterizes what ESG investing actually is. As discussed above, much of ESG investing today does not use the automatic ESG exclusionary strategy criticized by some anti-ESG advocates. So, the criticism that ESG investing is inherently irresponsible because it screens out high performers doesn't even apply to a huge swath of the ESG market.

And, in many cases, using the ESG exclusionary strategy criticized by Sharfman and others actually produces the opposite of what critics claim it does. In many instances, excluding companies with "bad" ESG metrics can *cause* <u>out</u>performance, as described above, rather than underperformance, exactly because the screened-out characteristics make those "bad" companies higher risk or poor investments. For example, many fossil-fuel exclusionary ESG funds have

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[60] SHIVAM GHOSH, J.P. MORGAN CHASE & CO., VIRTUE ISN'T THE ONLY REWARD 1 (15 March 2020). On file with the author, Courtesy J.P. Morgan Chase & Co., Copyright 2021.
[61] *Id.* at 2.
[62] *Id.* at 1.
[63] Nellie S. Huang, *6 Vanguard Funds That Are Socially Responsible,* KIPLINGER (April 26, 2017) https://www.kiplinger.com/slideshow/investing/t041-s003-6-vanguard-funds-that-are-socially-responsible/index.html.
[64] *Id.*
[65] Bernard S. Sharfman, *ESG Investing Under ERISA*, 38 YALE J. ON REGULATION BULLETIN 112,121-122 (2020).

outperformed other non ESG indexes *because* they screen out these high-risk fossil fuel companies that have underperformed in the past years.[66]

Evidence suggests that ESG funds, whether actively managed or exclusionary, specifically outperform in economic downturns,[67] as they are better insulated against downside risks. This type of outperformance makes sense because ESG factors align with many of the risks that may hurt a company during a downturn.[68] But whether ESG funds only outperform in a down market, outperform in all markets, or simply provide similar returns to non-ESG investments,[69] it's illogical to treat these types of investments any differently than other kinds of investments, given their similar, or in certain cases more favorable, returns to investors.

D. Demand for ESG

ESG investing has become extremely popular, both among individual and institutional investors. ESG's popularity is due to two factors. The first, of course, is the nature of ESG as valued-based. ESG's global value proposition speaks to all values-based investors, and specifically to millennials, who are overrepresented in the recent growth in demand for ESG investment products. Between 2015 and 2019, interest in sustainable investing jumped from 71% to 85% in the general population of investors, but from 84% to 95% in millennial investors.[70] A 2019 Ernst & Young report found that "demand for sustainable investments is being driven, in part, by millennials who prefer to investment in alignment with personal values."[71]

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[66] *Now You Can Compare Fossil Free Funds to Index Funds*, Fossil Free Funds (May 20, 2020), https://fossilfreefunds.org/blog/2020/05/20/now-you-can-compare-fossil-free-funds-to-index-funds.html ("Over the past 12 months, again the basic S&P 500 fund is lowest (+0.83), the Parnassus fund is next (+1.58), and the "fossil fuel reserves free" is outperforming (+1.99)."); Jeff Benjamin, *As Pandemic Rages On, ESG Funds Shine Brightly*, INVESTMENTNEWS (April 19, 2020), https://www.investmentnews.com/as-pandemic-rages-on-esg-funds-shine-brightly-191673 ("Part of the strength of ESG strategies in the current downturn can be attributed to the fact that most ESG funds have limited exposure to the fossil fuel industries, which have suffered so far this year.")

[67] *Id.*

[68] Tom Lauricella, Jess Liu, *Sustainable Funds Weather Downturns Better Than Peers*, MORNINGSTAR (Jun. 15, 2020), https://www.morningstar.com/articles/988114/sustainable-funds-weather-downturns-better-than-peers ("...evidence continues to build that ESG funds provide less downside risk than do their traditional peers. Investing in sustainable strategies has the potential to offer investors beneficial portfolio risk attributes and downside cushioning over short- and long-term time horizons. Add in the long-run benefits of investing in companies better poised to navigate risks poised by climate change or highlighted by the COVID-19 pandemic, and the ESG story is becoming more compelling.")

[69] Russel Kinnel, *How Vanguard, Fidelity, and Others Embrace ESG Investing*, MORNINGSTAR (Jun 2, 2020), https://www.morningstar.com/articles/986785/how-vanguard-fidelity-and-others-embrace-esg-investing ("Will ESG Investing Improve My Performance? The answer is to be determined. When I've looked at the data, it always shows that ESG funds collectively have average performance. Or, to put it another way, an ESG focus doesn't help as much as its biggest cheerleaders say, nor does it hurt as much as its critics say. To me, that makes sense. A sustainable focus ought to be a positive, but on the other hand, many low-ESG companies like tobacco or oil trade at very low valuations because of those liabilities. Perhaps that cheapness will be sufficient to compensate investors for taking on those risks. However, as I mentioned, ESG has evolved significantly in approach and in terms of the firms managing those strategies. So, even if the past data showed a more meaningful performance pattern, I'd be wary of projecting that into the future.")

[70] MSCI, SWIPE TO INVEST: THE STORY BEHIND MILLENNIALS AND ESG INVESTING 3 (March 2020), https://www.msci.com/documents/10199/07e7a7d3-59c3-4d0b-b0b5-029e8fd3974b#:~:text=%E2%80%9CDemand%20for%20sustainable%20investments%20is,management%20clients%20at%20Ernst%20%26%20Young.

[71] *Id.*

The second factor leading to the increase in demand for ESG products, especially more recently, is the continued high performance of ESG funds, due to their inclusion of additional risk factors into the traditional financial analysis. Individual investors and analysts and managers at institutional investment shops are citing *performance* as their main driver of ESG investing.[72] ESG investing truly is both good for the planet and for our portfolios.

Individual investors, who are among the millennial population and the general investor population, are increasingly turning to sustainable investing as a way to align their investment decisions with their values, while making good returns in the process. A 2017 study from Nuveen showed that 4 out of 5 investors "want their investments to make a positive impact on society and on environmental sustainability."[73]

These individual investors are not naive, nor are they subjugating returns to their values. A recent study on individual investors reported that a majority of investors cited *performance* as their main motivation for investing in these types of responsible investments.[74] 53% cited "better performance" and 46% cited "aligns with my values."[75] ESG investments offer investors a rare opportunity to marry their values with increased financial returns. Institutional investors are also recognizing the financial benefits of investing in ESG, and many even incorporate ESG analysis into their non-ESG funds.[76]

Despite all of this institutional and individual investor interest in ESG investments, 401(k) plans are woefully behind when it comes to offering ESG options for their retirement investors. While one-third of all professional managed assets are invested in funds using ESG strategies (a total of $17 trillion),[77] and $1.7 trillion are invested directly in ESG funds,[78] these are almost exclusively held in non-ERISA regulated [definitionally non-401(k) accounts].[79] Just 3% of employers offer an ESG option in their 401(k) lineup and only 0.1% of overall 401(k) assets (less than $9 billion) are currently invested in an ESG fund.

But this discrepancy between the percent of retirement assets invested in ESG and the percent of overall assets in ESG is *not* due to lack of investor interest—it is due to the high regulatory burden placed on fiduciaries of retirement plan funds. This article posits that, if that barrier were lowered, retirement plan assets would shift towards sustainable investments, increasing the overall total of assets invested in sustainable business.

This change would be good for the planet, since it rewards ESG-friendly options and incentivizes other companies to follow suit, and is good for retirement plan participants, since

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[72] SHIVAM GHOSH, J.P. MORGAN CHASE & CO., VIRTUE ISN'T THE ONLY REWARD 1 (15 March 2020). On file with the author, Courtesy J.P. Morgan Chase & Co., Copyright 2021.
[73] Jon Hale, *3 Myths About Sustainable Funds*, MORNINGSTAR (Sept. 18, 2019), https://www.morningstar.com/articles/946453/3-myths-about-sustainable-funds.
[74] *Performance Tops Investors Motives for Responsible Investing,* Nuveen (June 12, 2020), https://www.nuveen.com/en-us/insights/responsible-investing/fifth-annual-responsible-investing-survey.
[75] *Id.*
[76] Leslie P. Norton, *401(k) Plan Managers Will Promote ESG Funds Despite Pushback,* BARRONS (Oct. 1, 2020), https://www.barrons.com/articles/401-k-plan-managers-will-promote-esg-funds-despite-pushback-51601580478.
[77] PARNASSUS INVESTMENTS, REPORT ON US SUSTAINABLE AND IMPACT INVESTING TRENDS 1 (2020) https://www.ussif.org/files/Trends%20Report%202020%20Executive%20Summary.pdf.
[78] Simon Jessup & Elizabeth Howcroft, *Sustainable Fund Assets Hit Record 41.7 Trillion in 2020: Morningstar,* Reuters (Jan. 28, 2021), https://www.reuters.com/article/us-global-funds-sustainable/sustainable-fund-assets-hit-record-1-7-trln-in-2020-morningstar-idUSKBN29X2NM.
[79] Greg Iacurci, *Climate Funds Hold Less than 1% of 401(k) Money: Here's Why.* CNBC (Dec. 14, 2020), https://www.cnbc.com/2020/12/11/heres-why-401k-plans-lag-in-green-investment-options.html.

they can direct their assets towards funds they believe in, and trust they will have as good, if not better, returns down the line.

II. THE RETIREMENT CRISIS, AND WHAT ESG CAN DO ABOUT IT

The extent of the retirement crisis facing Americans is well-documented and well-known.[80] The typical (median) American worker has $0 saved for retirement.[81] 40% of Americans have a retirement savings account, but the median amount saved is only $40,000, while the recommended savings target is six times current income at age 50.[82] Americans are well-aware of their own retirement insecurity -- 65% are convinced they will have to work past the normal retirement age in order to afford to retire[83] and 51% predict tthey will be unable to maintain their current standard of living in retirement.[84]

Congress has attempted to address this retirement crisis over the past two decades. with major retirement-specific legislation, like the Pension Protection Act[85] and the SECURE Act.[86] Congress has also tried incremental changes to encourage more retirement savings, such as creating new forms of retirement accounts such as Roth IRAs or creating other tax-advantaged savings vehicles like health savings accounts.[87] But the retirement crisis still persists.

More action is needed to encourage more people to save for retirement. Allowing employees to invest their retirement dollars in value-based investment vehicles may encourage additional retirement savings, especially for younger workers, as it would allow them to align their retirement savings with their personal values. This could be achieved by a simple regulatory change at the agency level and would not require the expensive and protracted wrangling and politicking that comes with large-scale Congressional action.

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80 David A. Pratt, *Too Big to Fail? The U.S. Retirement System in 2019*, 27 ELDER L. J. 327, 328 (2020); David English, *Covid-19 and its Impact on America's Retirement System*, 46 ACTEC L. J. 35, 35 (2020); Regina T. Jefferson, *"Let Them Eat Cake": Examining United States Retirement Savings Policy Through the Lens of International Human Rights Principles*, 31 HARV. HUM. RTS. J. 63, 64-66 (2018); Chris Farrell, *Analysis: The Pandemic is Making America's Retirement Crisis Worse. Here's What You Can Do*, PBS (April 30, 2020), https://www.pbs.org/newshour/economy/analysis-the-pandemic-is-making-americas-retirement-crisis-worse-heres-what-you-can-do; Teresa Ghilarducci & Tony James, *America's Retirement Savings Crisis is Now. Here's How to Fix It*, CNN (Sept. 15, 2020), https://www.cnn.com/2020/09/15/perspectives/retirement-savings-crisis/index.html.

81 U.S. SENATE JOINT ECONOMIC COMMITTEE, RETIREMENT INSECURITY 2, https://www.jec.senate.gov/public/_cache/files/0fddd609-a00d-44da-aba8-cd15357010d9/retirement-insecurity-jec.pdf.

82 *Id.*

83 *Id.*

84 Anne Tergesen, *More Americans Face Retirement Insecurity*, WALL ST. J. (Jan. 19, 2021), https://www.wsj.com/articles/more-americans-face-retirement-insecurity-11611064810.

85 Julia Kagan, *Pension Protection Act of 2006*, INVESTOPEDIA (Nov. 27, 2020), https://www.investopedia.com/terms/p/pensionprotectionact2006.asp#:~:text=The%20Pension%20Protection%20Act%20sought,their%20401(k)%20plan.

86 Daniel Kurt, *What Is the SECURE Act and How Could it Affect Your Retirement*, INVESTOPEDIA (Mar. 19, 2021), https://www.investopedia.com/what-is-secure-act-how-affect-retirement-4692743.

87 Taylor Tepper, *How to Fix America's Retirement Crisis: 10 Experts Weigh In,* FORBES: ADVISOR (Feb. 1, 2021), https://www.forbes.com/advisor/retirement/how-to-fix-retirement-crisis/.

A. *Millennial Retirement Insecurity*

Retirement insecurity is especially heightened among millennials. 77% of millennials fear they'll either never retire or will have to work far past the normal retirement age, as compared to 36% of Gen Xers and 29% of baby boomers.[88] A research study by Aon Hewitt determined that millennials are at the highest risk of retirement insecurity compared to older generations, and predicted that eight out of ten millennials will not be able to meet their financial needs in retirement without significant changes in their saving and investing behaviors.[89]

Ninety-five percent of working millennials have insufficient retirement savings.[90] Two-thirds of working millennials, or 54.9 million young Americans, have no retirement savings at all.[91] Among those millennials who are saving for retirement, most are still vastly under saving. The median account balance in millennial retirement accounts is $19,100.[92] Some financial professionals suggest this generation should save between $1.8 to $2.2. million for retirement, or between 15-22% of their annual income.[93] Yet currently, the 85% millennials who have retirement savings are saving less than 6%, with an average employee retirement savings rate of 5%.[94] This lack of savings is especially shocking given that 60% of surveyed millennial investors agreed with the statement ""I expect Social Security to go bankrupt before I retire" (as compared to 47% of overall workers.)[95]

One of the main reasons millennials are woefully underprepared for their financial needs in retirement is because of the outsized impact the shift from defined-benefit to defined-contribution plans has had on this generation. Defined-benefit plans have all but disappeared, especially for millennial workers, and employers have recplaed this retirement benefit with 401(k) type plans.[96] 401(k) plans may be better from an employer-persepctive, but from an employee persepctive, they make retirement security much less secure. While many employers offer an employer match where they contribute towards the employee's 401(k) type plan, this match is nothing like the defined benefit pension plans of the past.

In a defined benefit plan, the employer bears most of the market risk and has the burden of ensuring that the pension is adequately funded and manages to provide adequate retirement income for the employees. In a 401(k)-type plan, the employee bears that risk. Unlike with a traditional defined benefit pension plan, workers with 401(k) type plans do not have any

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[88] Tom Conway, *Why Retirement Insecurity is the New American Epidemic*, WORKPLACE FAIRNESS (Mar. 3, 2020), https://www.workplacefairness.org/blog/2020/03/03/why-retirement-insecurity-is-the-new-american-epidemic/.

[89] *Employment Alert: Young Workers Face Hard Times in Retirement*, 28 No. 1 EMP. ALERT 11 (Jan. 14, 2011), available at https://www.westlaw.com/Document/I873fa4701d7c11e08b05fdf15589d8e8/View/FullText.html?transitionType=Default&contextData=(sc.Default)&VR=3.0&RS=cblt1.0.

[90] JENNIFER ERIN BROWN, NATIONAL INSTITUTE ON RETIREMENT SECURITY, MILLENNIALS AND RETIREMENT: ALREADY FALLING SHORT 22 (Feb. 2018), https://www.nirsonline.org/wp-content/uploads/2018/02/Millennials-Report-1.pdf.

[91] *Id.* at 1.

[92] *Id.* at 14

[93] *Id.* at 15

[94] *Id.*

[95] *Generational Retirement Trends Study*, T. ROWE PRICE (2015), at slide 15, available at https://www.slideshare.net/TRowePrice/generational-retirement-trends-study-2015/12-1212By_Worker_GenerationMajor_Reasons_for.

[96] This paper will use "401k-type plans" as synonymous with "defiend contribution plans," though there are of course other forms of defined-contributions plans, such as 403(b) plans, etc.

guaranteed retirement savings—they bear the responsibility and risk of participating in the plan, contributing to the plan, and managing the plan.

The shift from employer-sponsored defined benefit plans (traditional pensions) to employer-sponsored defined contribution plans (401(k) like plans)[97] shifts the burden of who is responsible for ensuring the employee's retirement security. Traditional defined benefit pension plans are maintained by employers and contributed to by employers. Employees are not able to touch the retirement savings accruing in the pension plan until a specified retirement date. In a traditional defined benefit pension plan, employers hold the risk and liability for maintaining income for their employees in retirement. These plans guarantee employees a steady stream of income throughout retirement, typically determined based on average wages earned at a specified time prior to retirement. Traditional defined benefit pension plans are structured so that retirement benefits typically come close to replacing pre-retirement wages.[98]

401(k) type plans, on the other hand, place the burden of savings and investing those savings on the employee. The most common type of investment option in a 401(k) plan is a mutual fund or similar type of fund that pools participants' assets and is managed by a professional fund manager. The menu of investment options for employees is created by the employer, often with the help of plan service providers. There is usually a range of options (with an average of 14)[99] and employees can choose which option or options they would like to invest part or all of their retirement plan assets in. Requiring employees to manage their retirement savings is less desirable than the professionally managed defined benefit plan structure for many reasons, including that Americans are on average financially illiterate and lack basic knowledge required to make investment decisions.[100]

While the shift from traditional defined benefit pension plan to 401(k) type plans was detrimental to all employees, it has had a disproportionately detrimental impact on the newest generation of workers. These Millennial workers have found themselves on the losing end of two-tiered wage and benefit agreements, where companies continue pension benefits for older workers, while phasing them out for younger workers. Millennials almost exclusively have defined contribution plans instead of defined benefit plans.[101]

Millennial workers are also disproportionately affected by the self-directed nature of a 401(k) plan versus the employer managed nature of a traditional defined benefit pension plan. Millennials have the lowest rates of participation in 401(k) type plans compared to older generations of workers. Studies from both 2011 and 2018 showed that only half of millennials

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[97] 401(k) plans are the most common and well-known type of defined contribution plan, so this paper will use 401(k) to be synonymous with defined-contribution plans.

[98] Thomas Olson, *401(k) Leakage: Crafting a Solution Consistent with the Shift to Employer-Managed Retirement Accounts,* 20 ELDER L. J. 449, 453 (2013).

[99] Ian Yres & Quinn Curtis, *Beyond Diversification: The Pervasive Problem of Excessive Fees and "Dominated Funds" in 401(k) Plans,* 124 YALE L. J. 1476, 1485 (2015).

[100] Deepa Das Acevedo, *Addressing the Retirement Crisis with Shadow 401(k)s,* 92 NOTRE DAME L. R. online 38, 48-49 (2016); Jill E. Fisch & Tess Wilkson-Ryan et. al, *The Knowledge Gap in Workplace Retirement Investing and the Role of Professional Advisors,* 66 DUKE L.J. 633, 634 (2016).

[101] KATHERINE S. NEWMAN, DOWNHILL FROM HERE: RETIREMENT INSECURITY IN THE AGE OF INEQUALITY 9, https://books.google.com/books?hl=en&lr=&id=36hbDwAAQBAJ&oi=fnd&pg=PA1&dq=retirement+insecurity+america&ots=3bMR2jycG9&sig=HK33JttG1Uj2OZSmh1Hmp_kZsGQ#v=onepage&q=retirement%20insecurity%20america&f=false.

eligible to participate in a defined contribution plan did so.[102] And even those millennials who are participating in their 401(k) type plans are not saving enough.

B. ESG As a Marginal Savings Nudge

Employers seeking to increase participation in and contribution to an employer-sponsored, participant directed retirement savings plan should consider offering an ESG option in their investment lineup as a way to nudge more employees to save more dollars in these types of accounts. This could be particularly impactful for millennial workers, who are particularly interested in values-based investing.

Studies have shown that millennials consider companies' global impact before buying their product or investing in their business, and that millennials seek to tailor their investments to their values.[103] The financial industry recognizes the importance of ESG considerations to millennials, and uses ESG as a strategy to attract millennial investors.[104] Employers should do the same and entice more millennial employees to participate in and save more in their retirement plans by offering millennial-friendly ESG investment options.

To be clear, this is not a band aid that can solve all millennial economic woes. Offering an ESG option in the investment plan lineup will likely not encourage millennials who simply have no funds to invest to start investing in their 401(k). Millennials face record levels of student debt,[105] and, in some cases, it makes financial sense to use income to pay down student debt before saving for retirement.[106] Millennials may also be saving for a down payment, or using their income on childcare, the costs of which have both increased at a record pace. For millennial workers who simply have no discretionary dollars to invest after paying or saving for basic necessities and financing existing debt, opting out of a 401(k) may be the most financially savvy decision. But that is not all millennials.

Many millennial workers do have discretionary dollars left after they meet their basic needs each month, and it is these millennials who may save more if offered an ESG option. Only 39% of millennial workers who are eligible but do not participate in their 401(k) plans stated they have trouble meeting monthly expenses. Many millennials who opt out or under utilize their

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[102] *Employment Alert: Young Workers Face Hard Times in Retirement*, 28 No. 1 EMP. ALERT 11 (Jan. 14, 2011), available at https://www.westlaw.com/Document/I873fa4701d7c11e08b05fdf15589d8e8/View/FullText.html?transitionType=Default&contextData=(sc.Default)&VR=3.0&RS=cblt1.0; Press Release, National Institute on Retirement Security, New Research Finds 95 Percent of Millennials Not Saving Adequately for Retirement (Feb. 27, 2018), https://www.nirsonline.org/2018/02/new-research-finds-95-percent-of-millennials-not-saving-adequately-for-retirement/.

[103] MSCI, SWIPE TO INVEST: THE STORY BEHIND MILLENNIALS AND ESG INVESTING 1 (March 2020), https://www.msci.com/documents/10199/07e7a7d3-59c3-4d0b-b0b5-029e8fd3974b#:~:text=%E2%80%9CDemand%20for%20sustainable%20investments%20is,management%20clients%20at%20Ernst%20%26%20Young.

[104] Michal Barzuza, Quinn Curtis, & David Webber, *Shareholder Value(s): Index Fund **ESG** Activism and the New Millennial Corporate Governance*, 93 SO. CAL. L. REV. 1243, 1250 (2020), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3439516.1250.

[105] Millennials who are eligible but not contributing to a 401(k) have higher amounts of debt than millennials workers who are active in their 401(k) accounts. *Generational Retirement Trends Study*, T. ROWE PRICE (2015), at slide 55, available at https://www.slideshare.net/TRowePrice/generational-retirement-trends-study-2015/12-1212By_Worker_GenerationMajor_Reasons_for.

[106] Kevin Mercadante, *Should You Delay Retirement Contribution to Pay Off Debt?*, MONEY UNDER 30 (Nov. 11, 2020), https://www.moneyunder30.com/should-you-delay-retirement-contributions-to-pay-off-debt

401(k)s are simply saving elsewhere, likely in retail investment apps popular among millennials, like Robinhood.[107] For example, 8% of millennials eligible for 401(k)s but not participating in the 401(k) stated they don't participate because they are saving through other vehicles.[108] Additionally, 15% of millennials who are saving less than the maximum amount in their 401(k) stated they are under-saving in their 401(k) because they are using other investment vehicles.[109] These investment-savvy but non- or under- 401(k) participating millennials are the ones who could be enticed to save more for retirement if the 401(k) investment lineup spoke more to their investment values.

Millennial behavior on individual investment platforms such as Robinhood underscore this interest and also the fact that Millenials will indeed invest if the opportunity is a good match for their values. Robinhood's investor base is overwhelmingly millennial, with the average investor age of 31. And what these millennial investors are chasing through Robinhood is the trend of investing in clean energy.[110] But the disadvantage to using a Robinhood account to invest in sustainable companies is that in Robinhood investments are less tax-advantaged than 401(k) investments, and there is no potential employer match for Robinhood "contributions."[111]

If an employer offered a sustainable, environmentally friendly ESG fund within the tax-advantaged employer-sponsored retirement plan, especially if the company were matching employee contributions, it seems likely to redirect millennial savings away from tax-inefficient platforms like Robinhood and towards tax-efficient savings vehicles like 401(k)s. Not only would this provision of an ESG fund offer better returns and less investment risk for retirement plan assets,[112] but it would encourage greater millennial participation in and contribution to the plan in the first place.

Allowing employees to invest their 401(k) funds in a well-selected ESG investment option is not the be-all-end-all solution to millennial retirement woes. But it could encourage millennial workers, *at the margin*, to increase their retirement savings, at very little or no cost. And with the enormous impact that compound interest has on the value of dollars invested early in one's career, that marginal early investments could have an outsized impact on millennial retirement security.

III. ERISA Regulation of ESG Investing

There is clear and overwhelming individual and institutional interest for ESG investing, and including ESG funds in 401(k) lineups could have a marginal, yet significant, impact on increased economic security for millennials in retirement. The current regulatory framework for

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[107] Sean Williams, *Robinhood Investors Are Head-Over-Heels in Love With This Trend*, THE MOTLEY FOOL (Jan. 26, 2021), https://www.fool.com/investing/2021/01/26/robinhood-investors-head-over-heels-in-love-trend/.

[108] *Generational Retirement Trends Study*, T. ROWE PRICE (2015), at slide 58, available at https://www.slideshare.net/TRowePrice/generational-retirement-trends-study-2015/12-1212By_Worker_GenerationMajor_Reasons_for.

[109] *Id.* at slide 12.

[110] Sean Williams, *Robinhood Investors Are Head-Over-Hells in Love With This Trend*, THE MOTLEY FOOL (Jan. 26, 2021), https://www.fool.com/investing/2021/01/26/robinhood-investors-head-over-heels-in-love-trend/.

[111] Jean Folger, *Minimize Taxes and Maximize Your Bottom Line*, INVESTOPEDIA (Dec. 10, 2020), https://www.investopedia.com/articles/stocks/11/intro-tax-efficient-investing.asp.

[112] Paul A. Davies et al, *Pulling in Opposite Directions: Investor Community, US Regulators Diverge on Regulation of ESG Disclosures*, LATHAM & WATKINS (July 21, 2020), https://www.globalelr.com/2020/07/pulling-in-opposite-directions-investor-community-us-regulators-diverge-on-regulation-of-esg-disclosures/.

ESG investments, however, makes it difficult for Americans to invest their employer-sponsored retirement accounts in ESG funds.

Limiting ESG access for retirement plan assets not only keeps the trillions of dollars in 401(k) assets out of the sustainable market,[113] but it also limits the extent to which many Americans can even access ESG. More than 20 percent of American households' only form of investment ownership is an employer-sponsored retirement account.[114] Lowering the regulatory barriers to investing retirement funds in ESG will increase access to and investment in ESGs and could simultaneously encourage increased retirement savings.

Before delving into the history of ERISA and its subsequent regulations curtailing the inclusion of ESG options in ERISA-regulated investment plan lineups, I describe the regulatory framework, as it stands under the current rule, Financial Factors for Selecting Plan Investments (the "ESG Rule".) Although the Department of Labor announced in March 2021 that it would not be enforcing this rule, this is still the current rule that individual litigants can sue under if they believe they suffered losses to their plan because of the fiduciaries' decision to include an ESG option.

Furthermore, even if the Financial Factors rule is likely to be replaced by a more pro-ESG Rule in the next few years under the 2021 Department of Labor, the Financial Factors rule still sets the standard for how a retirement plan provider must act if they wish to include an ESG option today.

A. Trump's anti-ESG Rule

While the ESG Rule was not issued in its final form nor published until late 2020, the Trump Labor Department made it clear early that they would be taking a critical eye to ESG investing of retirement plan assets. A Field-Assistance Bulletin issued in 2018 warned that "fiduciaries must not too readily treat ESG factors as economically relevant to the particular investment."[115] The Department reiterated this lukewarm stance on ESG when issuing the ESG rule in 2020, warning that "private employer-sponsored retirement plans are not for furthering social goals or policy objectives but rather to provide for retirement security of workers."[116] The final rule did not explicitly *ban* ESG investments in retirement plan lineups. Instead, it laid out a complex process that fiduciaries needed to follow to ensure they did not violate their fiduciary duties by offering an ESG fund.[117]

The rule colloquially known as "the ESG Rule" doesn't even use the term ESG in the text of the rule (although it is all over the preamble.) Instead, the Labor Department's rule regulates the use of ESG funds by ERISA regulated fiduciaries through an opaque word—"pecuniary."

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[113] AMERICAN BENEFITS COUNCIL, 401(K) FAST FACTS (Jan. 2019), https://www.americanbenefitscouncil.org/pub/e613e1b6-f57b-1368-c1fb-966598903769.

[114] FINRA INVESTOR EDUCATION, SEC, A SNAPSHOT OF INVESTOR HOUSEHOLDS IN AMERICA 1 (Sept. 2015), https://www.sec.gov/spotlight/fixed-income-advisory-committee/finra-investor-education-foundation-investor-households-fimsa-040918.pdf.

[115] Elizabeth Goldberg & Julie Stapel, *Don't Call it ESG: The DOL's New Financial Facts Regulations and Their Impact on ESG Inesting and ERISA Fiduciary Duties More Broadly*, VIMEO (Dec. 17, 2020), at 7:45, https://vimeo.com/492216884/dd4468700c.

[116] Paul A. Davies et al, *Pulling in Opposite Directions: Investor Community, US Regulatory Diverge on Regulation of ESG Disclosures*, LATHAM & WATKINS (July 21, 2020), https://www.globalelr.com/2020/07/pulling-in-opposite-directions-investor-community-us-regulators-diverge-on-regulation-of-esg-disclosures.

[117] Craig Bitman et al, *DOL Finalizes 'Financial Factors' ERISA Regulation*, MORGAN LEWIS: LAWFLASH (Nov. 17, 2020), https://www.morganlewis.com/pubs/2020/11/dol-finalizes-financial-factors-erisa-regulation.

The rule lays out the types of factors that are permissible for fiduciaries to consider when choosing plan investments, namely "pecuniary" factors, and those that are impossible for fiduciaries to consider, namely "non-pecuniary" factors. The rule defines "pecuniary" as "a factor that a fiduciary prudently determined is expected to have a material effect on the risk and/or return of an investment based on appropriate investment horizons consistent with the plan's investment objectives."[118]

The regulation sets forth two exceptions to the pecuniary factors requirement. First, a fiduciary can choose plans that "promote, seek, or support non-pecuniary goals" as long as the investment choice can be justified solely on the basis of pecuniary factors.[119] The second exception is that a fiduciary can choose a plan based on non-pecuniary factors, as long as they can pass the "tie breaker test."[120]

In the first exception, a fiduciary who wants to include a plan that considered non-pecuniary (maybe ESG) factors can do so, as long as the fiduciary justifies the inclusion of this plan based solely on pecuniary (materially relevant economic) factors.

Of course, an employer who wanted to include an ESG option in their lineup could do this. *The premise of this entire paper* is that many ESG funds do rely on ESG as a clearly *pecuniary*, or economically relevant factor. But the fact that the rule requires fiduciaries to document this pecuniary benefit upfront,[121] rather than simply presuming that ESG considerations are pecuniary, and therefore economically relevant to the investment, is the *crux of the problem* with this regulation. It presumes that ESG factors are not pecuniary, or economically relevant, and therefore requires the fiduciaries to carry the burden of proving that they are, up front, before any beneficiary even complains about potential losses down the line.

In the case where a fiduciary either concedes that ESG factors are not pecuniary or does not want to go through the steps of proving they are pecuniary, the rule sets out another avenue a fiduciary can take to include an ESG investment in the lineup. The rule allows fiduciaries to use an exception known as the "tie breaker" exception, which traditionally was used when there was a tie between two exact investment options, so you can use non-pecuniary factors to "break the tie."[122] Here, fiduciaries are allowed to consider non-pecuniary factors, such as some ESG

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[118] Financial Factors in Selecting Plan Investments, 29 C.F.R. 2509.

[119] Craig Bitman et al, *DOL Finalizes 'Financial Factors' ERISA Regulation*, MORGAN LEWIS: LAWFLASH (Nov. 17, 2020), https://www.morganlewis.com/pubs/2020/11/dol-finalizes-financial-factors-erisa-regulation ("a fiduciary may consider investment funds that promote, seek, or support non-pecuniary goals… The DOL emphasized that this is a limited exception, which applies only if the alternatives can be justified solely on the basis of pecuniary factors.")

[120] Financial Factors in Selecting Plan Investments, 29 C.F.R. 2509 § d(2); *see also* Financial Factors in Selecting Plan Investments, 85 FR 72846, 72864 (Nov. 13, 2020)..

[121] Elizabeth Goldberg & Julie Stapel, *Don't Call it ESG: The DOL's New Financial Facts Regulations and Their Impact on ESG Investing and ERISA Fiduciary Duties More Broadly*, VIMEO (Dec. 17, 2020), at 27:45, https://vimeo.com/492216884/dd4468700c.

[122] Craig Bitman et al, *DOL Finalizes 'Financial Factors' ERISA Regulation*, MORGAN LEWIS: LAWFLASH (Nov. 17, 2020), https://www.morganlewis.com/pubs/2020/11/dol-finalizes-financial-factors-erisa-regulation ("The first exception is an updated formulation of the so-called "tie-breaker" rule first specifically stated in 1995 guidance—the concept that, all other things being equal based on risk and return considerations, a fiduciary is permitted to take into account non-financial considerations. Recognizing that all other things are rarely ever equal, the new formulation in the final rule (revised in response to comments) permits a fiduciary to apply non-pecuniary factors, and to make an investment decision based on such non-pecuniary factors, when the fiduciary is "unable to distinguish [among investment alternatives] on the basis of pecuniary factors alone.")

factors but only if the fiduciary again follows a lengthy documentation process upfront, justifying the consideration of these socially desirable but non-pecuniary factors.[123]

Requiring that documentation process upfront raises the same issue and question as the first exception—why are fiduciaries required to document the necessity or inherent value-add of looking to ESG factors when considering the value of an investment option? Why is there a higher burden upfront on funds using an ESG investing strategy versus any other type of proprietary active management strategy?

To reiterate, the Trump ESG Rule does not ban ESG options in retirement plans. The rule explicitly states in the preamble, "nothing in the final rule precludes a fiduciary from looking into certain types of investment alternatives in light of participant demand for those types of investments…."[124] It does, however, caution fiduciaries against ESG funds, warning fiduciaries that they should not "too hastily conclud[e] that ESG funds may be selected based on pecuniary factors or [under the "tie-breaker" rule] are not distinguishable based on pecuniary factors."[125] This regulation sets up walls of red tape, increasing the cost, burden, and litigation risk of offering an ESG option.

The Department of Labor's lukewarm stance on ESG investing of ERISA-regulated plan assets is one of the main reasons for, if not *the* main reason for, the lack of access to ESG investing in retirement plan lineups. As of 2019, 3% of 401(k) plans offer an ESG fund in their investment lineup.[126] The reason why that percentage is so low is because of the enormous burden fiduciaries face when seeking to include those funds in their plans, and the inherent risk of litigation to plans that offer them. The rule raises compliance costs and raises litigation risk for employers seeking to provide ESG options in their lineup, and it is understandable, given the enormous cost of ERISA litigation, why most employers chose to avoid the risk altogether.

As a result of the Trump ESG Rule's requirement that fiduciaries either justify ESG factors as pecuniary upfront, or go through the steps of the tie breaker, there are high compliance costs, and as a result, few employers offer ESG options in their lineups. Employers and their fiduciaries may feel the need to hire third party investment managers or plan consultants[127] to help them navigate the process of justifying including an ESG option, or to shield or offset liability in a potential ERISA suit down the line.[128] Other companies who cannot afford to hire these types of third-party advisors may simply choose not to include an ESG option.

This high burden and large compliance costs explain the massive discrepancy between non-retirement assets invested in funds using ESG investment strategies (1/3 of all professional

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[123] *Id.* ("To rely on this exception, the fiduciary is required to document why pecuniary factors were not sufficient, how the selected investment compares to the other comparable investments with regard to the prudence factors enumerated in the regulation, and how the chosen non-pecuniary factors are consistent with the interests of the plan participants and beneficiaries in their retirement income or financial benefits under the plan.")

[124] Financial Factors in Selecting Plan Investments, 85 FR 72846, 72864 (Nov. 13, 2020).

[125] Craig Bitman et al, *DOL Finalizes 'Financial Factors' ERISA Regulation*, MORGAN LEWIS: LAWFLASH (Nov. 17, 2020), https://www.morganlewis.com/pubs/2020/11/dol-finalizes-financial-factors-erisa-regulation.

[126] Greg Iacurci, *Climate Funds Hold Less than 1% of 401(k) Money. Here's Why.* CNBC (Dec. 14, 2020), https://www.cnbc.com/2020/12/11/heres-why-401k-plans-lag-in-green-investment-options.html.

[127] Elizabeth Goldberg & Julie Stapel, *Don't Call it ESG: The DOL's New Financial Facts Regulations and Their Impact on ESG Investing and ERISA Fiduciary Duties More Broadly*, VIMEO (Dec. 17, 2020), at 30:20, https://vimeo.com/492216884/dd4468700c.

[128] Emile Hallez, *ESG Could Thrive in 401(k) Plans, Despite DOL Rule*, INVESTMENTNEWS (Sept. 14, 2020), https://www.investmentnews.com/esg-future-401k-dol-rule-197100 ("One strategy that retirement plan advisers will likely be taking is to use a third-party fiduciary to evaluate ESG funds for plan menus, which could potentially shield advisers from some liability..."

managed assets)[129] versus retirement assets invested in ESG (less than 0.1% of 401(k) assets.)[130] It is not that employees don't *want* to invest in ESG, it's that employees *do not have access* to ESG.

This scarcity may be dissuading certain employees from participating in and contributing to their retirement plans. This negative impact on retirement savings behavior goes directly against the purpose of ERISA and the intent behind its strict regulation of plan fiduciaries.

To better understand why the 2021 Department of Labor not only *can* allow ESG options in retirement plans, but *should encourage* the inclusion of these options, this article will next discuss the context and goals of ERISA. A more fulsome understanding of the history of ERISA and the intention and operation of its strict fiduciary duties will help the reader understand why including ESG options in retirement plan lineups is directly in line with ERISA's intended goal of ensuring retirement security for American workers.

B. Background to ERISA

Most employer-sponsored retirement plans are regulated under the Employee Retirement Income Security Act of 1974 (ERISA). The provisions of ERISA that regulate retirement plans are administered by the U.S. Department of Labor.[131] ERISA was passed as the culmination of decades of legislative and activist efforts to address the retirement savings crisis in the United States and a long history of mismanagement of pension funds.[132]

One of the key turning points in the pension crisis that led to ERISA's adoption into law was the very public meltdown of the Studebaker automobile plant, which closed in 1963.[133] At the time the plant closed, it had over 10,000 employees enrolled in their pension plan.[134] Four thousand of those ended up receiving only 15 cents on each dollar they were owed, and 2,900 received nothing.[135] In the years following that plant closure and few more disastrous pension plan failures, NBC recorded and aired interviews of individuals who had lost their retirement savings and economic security due to mismanagement of their pension plans.[136] This exposure led to a public outcry, and the passing of ERISA.[137]

When ERISA was first passed, its goal was simple—to ensure employees' economic security in retirement.[138] ERISA attempts to strike a balance between sufficient regulation to ensure retirement plan assets are secure, and not too much regulation that would dissuade employers from providing retirement plans to begin with. As such, ERISA does not mandate

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[129] PARNASSUS INVESTMENTS, REPORT ON US SUSTAINABLE AND IMPACT INVESTING TRENDS 1 (2020), https://www.ussif.org/files/Trends%20Report%202020%20Executive%20Summary.pdf.
[130] Greg Iacurci, *Climate Funds Hold Less than 1% of 401(k) Money. Here's Why.* CNBC (Dec. 14, 2020), https://www.cnbc.com/2020/12/11/heres-why-401k-plans-lag-in-green-investment-options.html.
[131] *History of EBSA and ERISA*, U.S. DEPARTMENT OF LABOR, https://www.dol.gov/agencies/ebsa/about-ebsa/about-us/history-of-ebsa-and-erisa, last accessed April 14, 2021.
[132] *Id.*
[133] Rebecca J. Miller et al, *ERISA: 40 Years Later,* JOURNAL OF ACCOUNTANCY (Sept. 1, 2014), https://www.journalofaccountancy.com/issues/2014/sep/erisa-20149881.html.
[134] *Id.*
[135] *Id.*
[136] *Id.*
[137] *Id.*
[138] U.S. DEP'T OF LABOR, EMPLOYEE BENEFITS SECURITY ADMINISTRATION, FAQS ABOUT RETIREMENT PLANS AND ERISA 1, https://www.dol.gov/sites/dolgov/files/ebsa/about-ebsa/our-activities/resource-center/faqs/retirement-plans-and-erisa-for-workers.pdf, last accessed April 19, 2021.

that all companies must provide specific benefit plans, such as retirement plans. But ERISA does mandate that *if* an employer provides certain types of benefit plans, the plans must comply with ERISA standards.[139]

The employers who sponsor these plans, and any fiduciary providing investment services or management of these plans, are held to ERISA's strict fiduciary duties to serve the interest of plan participants. Plan participants can sue employer sponsors or fiduciaries for breach of fiduciary duty. The penalties for breach of fiduciary duty can be astronomical, and ERISA allows for fiduciaries to be held personally liable—so fiduciaries can be personally responsible for making beneficiaries whole for whatever they lost as a result of the fiduciary's mismanagement.[140] As such, companies and fiduciaries take extreme precaution to avoid any hint of fiduciary breach when it comes to ERISA-regulated plans.

ERISA requires plan fiduciaries to prioritize the interests of plan participants and beneficiaries when making investment decisions for the plan.[141] ERISA mandates specific fiduciary duties stemming from trust law and requiring fiduciaries to exercise the same standard of care and diligence that a prudent person would exercise under similar circumstances.[142] This is called ERISA's fiduciary duty of prudence. ERISA also mandates that fiduciaries must act solely in the interest of the participants and beneficiaries and for the exclusive purpose of providing financial benefits.[143] This requirement is also known as the fiduciary's duty of loyalty.[144] In addition to the duties of prudence and loyalty, the ERISA-regulated fiduciary also has the duties to diversify the plan's investments, follow the terms of a plan, and avoid conflicts of interest and statutorily prohibited transactions.[145]

Some types of ERISA-regulated plans, including 401(k)s, can be set up so that the participants choose where to direct their plan assets from a suite of employer-provided investment options. When selecting investment options for a plan such as a 401(k), the plan fiduciaries have specific obligations. Fiduciaries must have a "prudent process" that they rely upon when selecting investments and service providers, must ensure that fees and other expenses are reasonable, must select investments that are both "prudent" and "adequately diversified", and monitor the investment options and service providers to make sure they continue to be appropriate choices for the plan.[146]

C. ERISA's Fiduciary Duties and Fiduciaries' Selection of Plan Investment Options

If an employer wants to offer an ESG investment option, such as one of the ESG choices detailed above, the employer and any other fiduciaries involved in the decision must tread

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139 *Id.*
140 *Id.* at 11
141 David H. Webber, *The Use and Abuse of Labor's Capital,* 89 NYU L. Rev. 2108, 2109 (2014), https://www.nyulawreview.org/wp-content/uploads/2018/08/NYULawReview-89-6-2106-Webber.pdf.
142 29 U.S.C. § 1104(a)(1) (2012).
143 ERISA § 404(a)(1)(A); 29 CFR § 2550.404a-1; Kevin Long, *What It Means To Be an ERISA Fiduciary,* EMPLOYEE BENEFITS LAW GROUP (June 29, 2015), https://www.employeebenefitslawgroup.com/what-it-means-to-be-an-erisa-fiduciary/.
144 *Id.*
145 William J. Swartzwelder, *Employment Law-- The Split over the Shift: The Burden of Proving Causation in Claims for Breach of Fiduciary Duty under ERISA*, 41 U. ARK. LITTLE ROCK L. REV. 141, 145 (2018).
146 U.S. DEP'T OF LABOR, EMPLOYEE BENEFITS SECURITY ADMINISTRATION, FAQS ABOUT RETIREMENT PLANS AND ERISA 12, https://www.dol.gov/sites/dolgov/files/ebsa/about-ebsa/our-activities/resource-center/faqs/retirement-plans-and-erisa-for-workers.pdf, last accessed April 19, 2021

carefully to avoid running afoul of ERISA's regulations governing investment selection. Specifically, fiduciaries need to make sure they do not run afoul of ERISA's duties of loyalty and prudence.

The duty of loyalty issue is whether the fiduciary is allowed to consider benefits that this type of investment option has on anyone other than the beneficiary—is it a violation of the duty of *exclusive* loyalty to the beneficiary if the plan not only benefits the beneficiary and his assets, but also benefits a third party, such as the fund manager, or the planet? Does that collateral benefit mean that the fiduciary selecting an ESG option for inclusion in the lineup has violated ERISA's duty of loyalty? This is a procedural question—regardless of how positive the financial performance of the ESG option is, does the fact that it also inherently benefits a third party make it strictly off-limits for an ERISA-regulated plan?

The second issue is that of the duty of prudence. This issue gets to the investment research process the fiduciary engaged in when choosing the investment choice, as well as the substantive quality of the specific investment option included in the plan. Is it prudent, or financially sound, to include an option in the lineup that only invests in companies that have positive ESG impact? Presumably, this issue will depend upon what research the fiduciary undertook when choosing the specific option, and how good of a financial investment the specific ESG option is.

1. ERISA' Duty of Loyalty and ESG Investing

The first fiduciary duty that comes up when discussing inclusion of ESG funds in a plan's lineup, and the one specifically targeted by the Trump ESG rule,[147] is the fiduciary duty of loyalty. ERISA's fiduciary duty of loyalty requires plan fiduciaries to act in the best interest of their beneficiaries' plan assets, from an economic perspective. Fiduciaries cannot take into account the larger scope of "best interest", like making a different investment decision that might be better for the beneficiaries' work environment.

This narrow scope of "best interest" is dubbed "fund-first" by David Webber in his article "The Use and Abuse of Labor's Capital," where he criticizes this narrow focus.[148] Webber summarizes this understanding of the duty of loyalty as follows: "Under this same view, trustees might similarly breach their fiduciary duties by negotiating to protect their participants' jobs at

[147] James Marasciullo & Gretchen Harders, *DOL's Final Rule on Investment Duties of ERISA Fiduciaries and its Impact on Retirement Plan ESG Investing,* NATL. L. REV. (Jan. 8, 2021), https://www.natlawreview.com/article/dol-s-final-rule-investment-duties-erisa-fiduciaries-and-its-impact-retirement-plan ("The Final Rule clarifies that ERISA's duty of loyalty, which requires a fiduciary to act solely in the interest of plan participants and beneficiaries for the exclusive purpose of providing benefits and defraying expenses, applies to the evaluation of investments and investment courses of action. The Final Rule therefore states that the duty of loyalty forbids ERISA fiduciaries from sacrificing investment returns or taking additional risks to promote non-pecuniary goals. Thus, ERISA fiduciaries may not select ESG investments to promote any goal other than ensuring financial benefits for plan participants.")

[148] David H. Webber, *The Use and Abuse of Labor's Capital,* 89 NYU L. Rev. 2108, 2110-11 (2014), https://www.nyulawreview.org/wp-content/uploads/2018/08/NYULawReview-89-6-2106-Webber.pdf. ("Under the ascendant view of ERISA and state fiduciary duties, consideration of the impact of a fund's investments on the jobs of fund participants is worse than irrelevant; it is considered to be a breach of the duty of loyalty and the exclusive purpose rule. This is because the dominant interpretation of the fiduciary duties of public pension trustee requires them to prioritize the investment impact on the fund alone, and not its impact on the funds' participants and beneficiaries, like Thorne. Even in the extreme case, in which an investment by a public pension fund in a company that competes with public employees is the proximate cause of the employees' loss of employment, the employees' lost compensation or benefits is irrelevant to the fiduciary analysis.")

some cost to return on investment, even if it would improve the investment's net economic benefit to fund participants and beneficiaries."[149]

This article does not seek to criticize this fund-first approach to the duty of loyalty, no matter how many good points David Webber brings up in his astute critique. This article simply seeks to clarify that, under the duty of loyalty, a fiduciary has a duty to make investment decisions that are in the sole interest of the beneficiaries' assets in the plan. If the fiduciary takes other considerations into mind and makes a slightly worse economic decision that has slightly more extrinsic favorable impacts, like on the beneficiary's job security, or on global warming, that subjugation of the plan assets to that collateral benefit would be a violation of the fiduciary's duty of loyalty.

But what if the consideration of collateral benefits does NOT cause the plan or its participants to lose money? What if we had a win-win scenario, like that offered by many prudent ESG investment options, where a fund's consideration of ESG factors actually led to similar or increased economic benefits for the beneficiaries' assets? [150] Would it be a violation of the duty of loyalty if, in addition to being in the best interest of the beneficiary's assets, a fiduciary's investment decision also had a positive impact on a third party, say, the planet?[151]

ERISA case laws answers this question clearly—no. It is not a violation of the duty of loyalty to make a decision that is both in the *best* interest of the beneficiaries' assets *and* provides a collateral benefit to a third party. To establish a breach of fiduciary duty of loyalty, the fiduciary would have needed to value someone else's benefits *over* the benefits to the participant's assets.[152] The district court in *Donovan v. Walton* clarified this point when it wrote that ERISA's duty of loyalty "does not prohibit a party other than a plan's participants and beneficiaries from benefitting in some measure from a prudent transaction with the plan. Furthermore, by adopting the 'exclusive purpose' standard, Congress did not intend to make illegal the fact of life that most often a transaction benefits both parties involved."[153]

From a court's perspective, it doesn't matter who the third party is—it could even be a decision that benefits the actual fiduciary, as was the case in *Metzler v. Graham*.[154] It's not much of a logical jump to assume that it could also be a decision that happens to benefit the planet. As long as it is in the best interest of the beneficiaries' portfolio, precedent would suggest it doesn't

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[149] *Id.* at 2112.

[150] *See* SHIVAM GHOSH, J.P. MORGAN CHASE & CO., VIRTUE ISN'T THE ONLY REWARD 3 (15 March 2020). On file with the author, Courtesy J.P. Morgan Chase & Co., Copyright 2021. ("…constraining the investment universe to only the top rated ESG issuers not only improves the ESG profile of a portfolio but also boosts alpha. Our results seem to suggest that ESG integration into active mandates should be a 'why-not?' proposition for fund managers given the ethical and financial rewards.")

[151] *Id.* ("…constraining the investment universe to only the top rated ESG issuers not only improves the ESG profile of a portfolio but also boosts alpha. Our results seem to suggest that ESG integration into active mandates should be a 'why-not?' proposition for fund managers given the ethical and financial rewards.")

[152] Tibble v. Edison, No. 2:07-cv-05359, 2010 WL 2757153, at *24 n.19 (C.D. Cal. Jul. 8, 2010), aff'd, 711 F.3d 1061 (9th Cir.), aff'd en banc, 729 F.3d 1110 (9th Cir. 2013); rev'd on other grounds, 135 S. Ct. 1823 (2015), aff'd on remand, 2016 WL 1445220 (9th Cir. April 13, 2016). The Fourth Circuit held that a fiduciary breached its duty where it acted out of "fear of liability, not out of concern for its employees' best interests." Tatum v. RJR Pension Invest. Comm., 761 F.3d 346, 361 (4th Cir. 2014), petition for cert. denied, 135 S.Ct. 2887 (2015).

[153] Donovan v. Walton, 609 F. Supp. 1221, 1245 (S.D. Fla. 1985).

[154] Metzler v. Graham, 112 F.3d 207 (5th Cir. 1997) (plan administrator did not breach his fiduciary duty when he caused the plan to purchase land adjacent to his own, thus increasing the value of his land, because there was no evidence the plan administrator placed his own interests above that of the plan's and it actually increased the value of the plan's assets).

violate the duty of loyalty if it also happens to help the planet. The fiduciary can make an investment decision that is good for the planet, as long as it's the *best* one for the portfolio.

In his article criticizing ESG investing and arguing for exclusion of ESG funds from retirement plans, Bernard Sharfman claimed that investing in ESG plans would inherently violate ERISA's duty of loyalty because of the collateral benefits it would have on society.[155] He argued that if a fund strategy pursued non-financial goals, such as cleaning up the environment, or excluding investments in guns or tobacco, that collateral benefit would violate the sole benefit rule and make the fiduciary liable for breach of his duty of loyalty.

This argument fails to recognize that a fiduciary can do both. If a fiduciary chooses an actively managed fund that pursues the highest risk-adjusted return possible by including ESG factors in the investment and screening out "bad" ESG companies because of their inherent volatility and risk, that fiduciary would not be breaching his duty of loyalty. That fiduciary would be following the portfolio management advice that the finance industry is shouting from the rooftops: fiscally responsible investing requires analysts to consider the risks posed by certain ESG factors and exclude "bad" ESG companies from funds if they pose too big of a risk to the funds' return.

Trust law professor Susan N. Gary emphasized that prudent selection of an ESG fund would not violate a fiduciary's duty of trust, because "growing evidence suggestions that ESG information may improve returns, especially when a longer time horizon is considered."[156] As such, she argued in a 2019 article that, "[a]s long as a strategy does not involve sacrificing financial returns, then even if the duty of loyalty is defined as the duty to act solely in the financial interests of the beneficiaries, the duty of loyalty is not compromised by a direction to invest using a strategy that incorporates ESG criteria."[157]

This way of thinking about ESG investing as permissible within the duty of loyalty is consistent with the public policy and purpose of ERISA. Congress drafted ERISA to encourage employers to establish retirement savings plans.[158] ERISA preempts state legislation and offers some protection to employers because Congress recognized that too much liability, or too much confusion about which law prevails, will dissuade companies from offering retirement plans.[159] Uncertainty and increased liability raise compliance costs, and higher compliance costs of benefit plans will necessarily translate to fewer benefit plans.

Here too, if there is too much liability risk surrounding offering ESG, as under the Trump-era rule, employers simply won't offer it. We see that playing out right now, with only

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[155] Bernard Sharfman, *ESG Investing Under ERISA*, 38 YALE J. ON REG. BULLETIN 112, 129 (2020).

[156] Susan N. Gary, *Best Interests in the Long Term: Fiduciary Duties and ESG Integration,* 90 U. COLORADO L. REV. 731, 788 (2019).

[157] Susan N. Gary, *Best Interests in the Long Term: Fiduciary Duties and ESG Integration,* 90 U. COLORADO L. REV. 731, 799 (2019).

[158] *ERISA: What You Need to Know*, BLR.COM, https://www.blr.com/compensation/retirementplanning/erisa, last accessed April 19, 2021.

[159] VANESSA SCOTT, AMERICAN HEALTH POLICY INSTITUTE, THE NEED TO STRENGTHEN ERISA PREEMPTION 1 (2017), https://www.americanhealthpolicy.org/Content/documents/resources/The_Need_to_Strengthen_ERISA_Preemption.pdf.

3% of employers offering an ESG option,[160] even as supply of and demand for these high-quality investment options is exploding.[161]

2. ERISA's Duty of Prudence and ESG

The second fiduciary duty that is potentially at play in fiduciary's wariness towards ESG is the duty of prudence. ERISA's fiduciary duty of prudence requires a fiduciary to investigate and consider the relevant facts and circumstances of the investment choice. The duty does not require a fiduciary to be prescient, or predict the actual outcome of an individual investment decision.[162] The duty of prudence does require that the fiduciary determine that a particular investment is reasonably designed, and take into consideration the risk of loss and opportunity for gain, including factors such as the diversification of the plan, the liquidity of the plan, and the projected return of the plan.[163] This duty basically asks the question, "did the fiduciary do his or her due diligence?"

This duty looks more at the decision-making process, and less at the actual performance of the selected investment. The duty of prudence depends on industry norms, and requires the fiduciary to do the research and consider the factors that a prudent investor would.[164]

Courts have found a breach of the fiduciary duty of prudence when the fiduciary did not engage in adequate process. For example, in *Katsaros v. Cody*, the Second Circuit found there was a fiduciary breach of the duty of prudence because the pension fund made a $2 million loan to a bank simply relying on a short presentation by the bank and without obtaining an independent professional appraisal or analysis of the bank or collateral. There, the fiduciary breached his duty of prudence because he did not do enough work to determine that the loan was a safe one that would reasonably be repaid to the pension fund.[165]

Another example of a court finding a fiduciary breached his duty of prudence for lack of due diligence in the process is *Zanditon v. Feinstein*, where the fiduciary merely relied upon a co-trustee's advice when selecting a plan and did not independently investigate the plan's merits. Here, he breached his fiduciary duty because he did not do his due diligence in researching the plan prior to investing in it.[166] Similarly, the Seventh Circuit found a fiduciary breached his duty of prudence when he agreed to a fee schedule after only discussing it for ten minutes and not giving it adequate study.[167]

In order for this failure of process to cause a breach of the duty of prudence, there must be a causal link between the failure to investigate and the harm suffered by the plan.[168]

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[160] Greg Iacurci, *Climate Funds Hold Less than 1% of 401(k) Money. Here's Why.* CNBC (Dec. 14, 2020), https://www.cnbc.com/2020/12/11/heres-why-401k-plans-lag-in-green-investment-options.html.

[161] Simon Jessup & Elizabeth Howcroft, *Sustainable Fund Assets Hit Record 41.7 Trillion in 2020: Morningstar*, Reuters (Jan. 28, 2021), https://www.reuters.com/article/us-global-funds-sustainable/sustainable-fund-assets-hit-record-1-7-trln-in-2020-morningstar-idUSKBN29X2NM; PARNASSUS INVESTMENTS, REPORT ON US SUSTAINABLE AND IMPACT INVESTING TRENDS 1 (2020) https://www.ussif.org/files/Trends%20Report%202020%20Executive%20Summary.pdf.

[162] *How is Prudence Defined Under ERISA?*, PLIANCED, https://www.plianced.com/compliance-wiki/how-is-prudence-defined-under-erisa/, last accessed April 19, 2021.

[163] *Id.*

[164] Susan N. Gary, *Best Interests in the Long Term: Fiduciary Duties and ESG Integration*, 90 UNIV. OF COLORADO L. REV. 731, 733 (2019).

[165] Katsaros v. Cody, 744 F.2d 270 (2d Cir. 1984).

[166] Zanditon v. Feinstein, 849 F.2d 692 (1st Cir. 1988).

[167] Brock v. Robbins, 830 F.2d 640 (7th Cir. 1987).

[168] Kuper v. Iovenko, 66 F.3d 1447, 1459 (6th Cir. 1995).

Additionally, if a fiduciary does not engage in the proper research process, but makes a decision that another "hypothetical prudent fiduciary" would have also made, that lack of research up front also does not rise to the level of breach of a fiduciary's duty of prudence.[169]

Given courts' interpretations of a fiduciary's duty of prudence, and the clear impact of ESG factors on a fund's performance, it seems there is an easy way for fiduciaries to avoid liability under their duty of prudence when selecting an ESG fund for the plan lineup. The fiduciary simply needs to engage in the same sort of research process he engages in when choosing any sort of fund for the lineup. This process should include asking fund managers about their strategy, their level of research, their expertise, their performance against a benchmark, their fees, etc. As long as other prudent investors are making similar choices (and millions of individual Americans and dozens of institutional investors are choosing to invest in ESG funds), then a fiduciary need not worry about a beneficiary-instigated or Department of Labor-instigated lawsuit for including a climate-friendly investment plan in the lineup.

Trust law professor Susan N. Gary argues that ESG investing does not violate the duty of prudence for these same reasons. In her article entitled "Best Interests in the Long Term: Fiduciary Duties and ESG Integration," she argues that the fluid nature of the duty of prudence, which changes with industry norms, means that as the financial industry has moved to adopt ESG investment practices, the duty of prudence now allows, or even requires, a prudent fiduciary to consider those factors as well.[170] Her article cited to a United Nations report issued in conjunction with the British law firm Freshfield Buckhaus Deringer, which analyzed fiduciary duties applicable to investment decision-making and "concluded that integrating ESG considerations into investment analysis was 'clearly permissible' and 'arguably required.'"[171]

The duty of prudence requires that fiduciaries take the factors into consideration that a prudent investor would—and prudent investors are starting to consider ESG factors *even in non-ESG funds*. These are important factors that contribute to performance and impact a company's bottom line. Including ESG factors are absolutely part of the process of doing due diligence on a company's valuation and exposure to risk. As cited above, the chief operating and compliance officer at a benefits firm explained that ESG considerations are simply "a new way of thinking about the extra layer of qualitative due diligence."[172] Additionally, a white paper released by the investment management firm Neuberger Merman stated that, "investors now expect that any robust investment process should integrate material ESG considerations, and they are increasingly seeking to define, measure and enhance the total impact of their investment."[173]

Institutional investors are investing in ESG because it is a good financial strategy. It is ludicrous for an ESG Rule to create a presumption that it is imprudent to consider ESG factors, when the financial industry is explicitly stating it is imprudent NOT to consider those factors.

To reiterate the point above, the current ESG Rule, as it stands, puts a higher burden on fiduciaries seeking to include ESG options in the lineup than fiduciaries seeking to include non-

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[169] Roth v. Sawyer–Cleator Lumber Co., 16 F.3d 915, 919 (8th Cir.1994).
[170] Susan N. Gary, *Best Interests in the Long Term: Fiduciary Duties and ESG Integration,* 90 UNIV. OF COLORADO L. REV. 731, 790-792 (2019).
[171] Susan N. Gary, *Best Interests in the Long Term: Fiduciary Duties and ESG Integration,* 90 UNIV. OF COLORADO L. REV. 731, 797 (2019).
[172] Emile Hallez, *ESG Could Thrive in 401(k) Plans, Despite DOL Rule,* INVESTMENTNEWS (Sept. 14, 2020) https://www.investmentnews.com/esg-future-401k-dol-rule-197100.
[173] JOSEPH V. AMATO & INGRID S. DYOTT, NEUBERGER BERMAN, ESG INVESTING: AN ACTIVE APPROACH TO LONG-TERM VALUE CREATION 1 (Jan. 2019) https://www.nb.com/documents/public/global/t0349_0119_wp_esg_investing_an_active_approach.pdf.

ESG investments in the lineup. The rule states that fiduciaries must prove the pecuniary nature of the ESG factors or avail themselves of the laborious tie-breaker exclusion, in order to avoid the risk of litigation. This placement of the burden of proof on the plan fiduciary upfront is directly counter to the placement of the burden for any other type of investment, where plan sponsors can choose to include any non-ESG fund in the plan, and only need to justify their fulfillment of the duties of loyalty and prudence down the line, *if* they get sued.

In addition, in an ERISA litigation suit, the burden of proving a fiduciary breached or did not breach his duty is *almost never* on the plan sponsor or the fiduciary![174] The burden of proving that the fiduciary breached his duty is on the plan participant, or plaintiff—the fiduciary almost never needs to prove it was *not* a violation of fiduciary duty (with a few rare, fact-specific exceptions.)[175] Mandating that a fiduciary has the burden of proving that including an ESG fund is not a violation of the duty of loyalty is a clear double standard for ESG plans, and it denies American investors the opportunity to avail themselves of one of the hottest and fastest growing investment vehicles in the industry.

IV. PRESIDENT BIDEN SHOULD "BUILD BACK" A "BETTER" ESG RULE

The current ESG Rule fails to recognize that employers can carry out ERISA's goal of secure retirement for American workers through offering an ESG option in retirement plan lineups. This article suggests two approaches the Department of Labor can take to encourage more employers to offer these attractive investment options to their employees. The Department of Labor can either (1) rewrite the rule to shift the presumption back to a presumption that ESG factors are pecuniary, or economically relevant, or (2) amend pre-existing safe harbor exceptions or create a new safe harbor exception for plans that offer an ESG option, as long as they follow certain requirements.

A. Shift the Presumption and Burden Back Where It Belongs

One approach the Department of Labor could take to explicitly allow employers to offer ESG options in their 401(k) lineups would be to rewrite the ESG Rule to make it clear that ESG factors should not be presumed to be non-pecuniary. In this scenario, the process for a fiduciary to select and include an ESG option in a 401(k) investment lineup would be exactly the same process they go through when choosing a non-ESG investment. The fiduciary could on his own, or with the help of an investment consultant, consider the plan's diversification, risk, fee

[174] William J. Swartzwelder, *Employment Law-- The Split over the Shift: The Burden of Proving Causation in Claims for Breach of Fiduciary Duty under ERISA*, 41 U. ARK. LITTLE ROCK L. REV. 141, 142 (2018) ("…a plan participant demonstrates the first two elements [that the allegedly breaching party is a fiduciary and that this fiduciary breaches a duty ERISA imposes on him]"); Michael W. Stockham & Mackenzie S. Wallace, *Fiduciary Duty Litigation and Burden Shifting,* ABA SECTION OF LITIGATION: TRIAL EVIDENCE COMM. at 2 (Mar. 4, 2014) ("Generally, plaintiffs have the burden of proving each element: (1) existence of a fiduciary duty, (2) breach of that fiduciary duty, and (3) damages directly stemming from that breach. Arizona, Arkansas, California, Colorado, New York, Oklahoma, Pennsylvania, and Washington have jury charge instructions that clearly set out that it is the plaintiff's burden to prove breach of fiduciary duty. The majority of states place the burden of proving each element of a breach of fiduciary duty on the plaintiff.") (citations omitted.)

[175] *Id.* at 2-4 (reviewing the few fact-specific incidences where the burden of proof of breach shifts to the fiduciary, including if the defendant-fiduciary profited or benefited from the transaction or in certain cases where the fiduciary is a director or officer of the company).

structure, and historical performance relative to a benchmark.[176] There would be no additional work required upfront if the fiduciary was investigating an ESG option as opposed to a non-ESG option.

Instead of fiduciaries needing to document up front their rationale for believing ESG factors to be pecuniary, or to go through the steps of the tie-breaker exception, the re-written rule could simply clarify that the Department of Labor presumes ESG factors are pecuniary, the same presumption that any other non-ESG fund is afforded. If a beneficiary disagrees, and in the case of a certain ESG plan, thinks that the type of ESG considerations in that plan were not sufficiently economically relevant to the plan's performance, the burden would be on the beneficiary to prove that point in the course of a lawsuit.

This presumption and burden shift would remove the double standard for ESG funds that currently places the burden on the fiduciary to upfront justify the consideration of ESG factors and their relevance to the investment decision. Additionally, this would remove the added litigation threat currently present in the ESG Rule which suggests that it is a violation of a fiduciary's duty of prudence to pick an investment option that has collateral benefits to the planet (even though, as documented excessively above, these plans are arguably *better* for the beneficiary, and certainly a fiduciary could demonstrate the plan selection was in the best interest of the participant.)

The fiduciary then would have the same duty to monitor the performance of the ESG option, just as they have the duty to monitor the performance of any other non ESG fund in the plan lineup.[177] If the ESG fund did not perform as predicted, or if any non ESG fund did not perform as predicted, the fiduciary should remove that fund and restart the research process to find a better one.

This type of rule would not require a fiduciary to justify up front if a specific ESG fund was using ESG characteristics that were pecuniary or not--it would simply care about the same things we care about in any plan investment selection: process and performance.

B. Encourage ESG Investment Inclusion by Creating a Safe Harbor for Lineups with ESG

An alternative method that the Department of Labor could pursue is to create a safe harbor to encourage plan fiduciaries to include ESG investment options in their plan's lineup. A safe harbor is a way to create an exception to ERISA for plans that meet certain requirements. If the plans meet the requirements of safe harbors, they are removed either from some ERISA reporting and testing requirements, or in certain cases, removed entirely from ERISA's jurisdiction.

Safe harbors have the effect of massively lowering the compliance costs for certain types of plans. ERISA reporting and compliance testing takes an enormous amount of time and is very

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[176] Donald Stone, *Investment Selection and Monitoring: A Practical Approach to Best Practices,* 401k Help Center, http://www.401khelpcenter.com/401k/stone_investment_selection.html#.YFEAdJ1Ki00, last accessed April 19, 2021.

[177] Tibble v. Edison Int'l, 2010 WL 2757153 (Jul. 8, 2010), aff'd in relevant part, 729 F.3d 1110 (9th Cir. 2013). Plaintiffs successfully petitioned the Supreme Court for certiorari to review that portion of the Ninth Circuit's order affirming summary judgment as to other claims on statute of repose grounds. The Supreme Court reversed the Ninth Circuit on that point, holding that, because fiduciaries have a continuing duty to monitor investments and remove imprudent ones under ERISA's duty of prudence, a plaintiff may allege a case that is timely under ERISA's six-year statute of repose by alleging that the defendant failed to perform this monitoring function during the six-year repose period. 135 S. Ct. 1823 (2015).

costly, so if a company can avoid the time and expense of those reports and tests by complying with a certain requirement from a safe harbor, in most cases they will comply with the safe harbor. This is a way that Congress or the Department of Labor can encourage plans to be drafted in certain ways, by effectively lowering the compliance costs and making it much cheaper for an employer to offer a certain kind of benefit plan. Congress and the Department of Labor have created a number of safe harbors for certain types of retirement plans, so this would not be a deviation from the norm.

One example of Congress creating a safe harbor to encourage a new type of retirement plan design is the safe harbor for plans that auto-enroll employees in their 401(k) retirement savings plans as they qualify, rather than requiring the employees to go through the hassle of enrolling themselves.[178] If an employee does not want to participate in the plan, they can opt out. The idea of auto-enrolling employees in retirement plans as a nudge to get them to participate in higher numbers, and thus save more for retirement, came from behavioral economist Richard Thaler, who eventually won the Nobel Prize for his research on behavioral economics and how employers could adjust plan design to automatically encourage more employees to save.[179]

Recognizing that auto-enrollment was a desirable feature for retirement plans, Congress created a safe harbor in the Pension Protection Act of 2006.[180] The safe harbor provided that 401(k) plans with an auto-enroll feature meeting certain requirements are exempt from the nondiscrimination rules and tests for deferrals and matching contributions, and are exempt from certain "top heavy" rules.[181] Unsurprisingly, retirement plan providers jumped at the chance to avoid the expensive and time-consuming nondiscrimination and top heavy rules, and exempted themselves from those rules by adjusting their plans to auto-enroll participants.

As a result of the safe harbor for plans that auto-enroll beneficiaries, plans with an auto-enroll feature doubled over the course of ten years, from 35.6% in 2007 to 59.7% in 2016.[182] This is not surprising. When regulation makes a certain type of plan construction cheaper, companies will adopt that type of plan construction. And, in this case, adopting this type of plan construction had massive positive impacts on plan participation and retirement saving--auto enrollment nearly doubled plan participation and successfully enrolled participants who otherwise would not have saved for retirement.[183] A Vanguard study from 2015 found that in recent years, auto-enrollment has more than doubled plan participation rates, from 42% without auto-enroll to more than 91% participation with an auto-enroll feature. This is an example of

[178] *Automatic Enrollment in 401(k)*s, PENSION RIGHTS CENTER, http://www.pensionrights.org/issues/legislation/automatic-enrollment-401ks, last accessed April 19, 2021.
[179] Ian Salisbury, *Meet Richard Thaler, the Man Who Just Won the Nobel Prize for Helping You Save for Retirement*, MONEY (Oct. 9, 2017), https://money.com/thaler-nobel-economist-retirement-savings-nudge/.
[180] RBC WEALTH MANAGEMENT, AUTOMATIC ENROLLMENT SAFE HARBOR 401(K) PLAN 1 (2021), https://www.rbcwm-usa.com/resources/file-687791.pdf.
[181] *Id.*
[182] *PSCA Study Shows Steady Increase in Automatic Features*, PLAN SPONSOR COUNCIL OF AMERICA, https://www.psca.org/news/press-room/psca-study-shows-steady-increase-automatic-features, last accessed April 19, 2021.
[183] JOSHUA DIETCH & TAHA CHOUKHAMANE, T. ROWE PRICE INSIGHTS, AUTO-ENROLLMENT'S LONG-TERM EFFECT ON RETIREMENT SAVING 1 (Nov. 2020), https://www.troweprice.com/content/dam/fai/Collections/DC%20Resources/Automated%20Services/AutoEnrollment.pdf. [183] Some scholars argue that this autoenroll feature may actually have backfired, and that participants would have saved more in the absence of this feature. *See* Ryan Bubb & Richard H. Pildes, *How Behavioral Economics Trims Its Sails and Why*, 127 Harv. L. Rev. 1594 (2014).

Congress intentionally lowering the compliance costs of ERISA for certain plans in order to encourage plans to be designed in that desirable way.

Other types of safe harbors completely shield fiduciaries from liability under certain conditions. The ERISA Section 404(c) safe harbor, for example, shields fiduciaries from liability for a beneficiary's investment decision that leads to plan losses. This safe harbor is also known as "the large menu defense." The 404(c) safe harbor states that as long as the plan offers a broad range of investment options, allows the beneficiary to control their investments, and sufficiently educates the beneficiary about the investment options, the fiduciary is not liable for an individual beneficiary's investment choice that leads to investment losses.[184] This means that, if a fiduciary sets out a large enough menu of investment choices in a lineup and properly educates the participant about the options, and the participant chooses an option that ends up performing poorly, the participant should not prevail in a lawsuit against the fiduciary to recover the loss of his plan assets.[185]

This safe harbor may sound like it already protects fiduciaries from liability for including an ESG plan in their lineup, as long as there are enough investment options in the lineup and the fiduciary provides enough information to educate the participant about his options.

The Department of Labor, however, explicitly explained that the 404(c) defense does *not* apply to plan investment selection decisions.[186] The Department of Labor clarified that the 404(c) shield cannot be used as a defense against an allegation of breach of the duty of prudence, and investment selection choices fall within the duty of prudence. Plan investments still must be prudently selected, and 404(c) will not protect a fiduciary who does not select good investment options. 404(c) only protects a fiduciary if one of those prudently selected investments ends up with poor performance, and the participant tries to sue the fiduciary for having invested in that option as opposed to one of the plan's other prudent options.[187]

Some courts have disagreed with the agency's interpretation of the 404(c) safe harbor, and argue that the 404(c) protection should extend to fiduciary decisions in selecting plan investments. The Third, Seventh, and Eighth Circuits have held that the 404(c) large menu defense *does* apply to protect fiduciary decisions made at the investment selection level.[188] Many of these cases have centered on the issue of excessive fees, where beneficiaries sued the fiduciary for losses to their plan assets due to an allegedly excessive fee structure. In numerous cases, these circuit courts have held that the 404(c) large menu defense applies, and that fiduciaries are

[184] John Manganaro, *ERISA 404(c) Compliance Well Worth the Effort,* PLANADVISOR: COMPLIANCE (Sept. 24, 2018), https://www.planadviser.com/exclusives/erisa-404c-compliance-well-worth-effort/.

[185] ERISA Section 404(c) FAQs, FindLaw: Employment Lawhttps://employment.findlaw.com/wages-and-benefits/erisa-section-404c-faqs-.html#:~:text=Section%20404(c)%20is%20a,of%20their%20own%20retirement%20accounts.&text=The%20section%20follows%20a%20prudent,the%20investments%20of%20their%20accounts, last accessed April 19, 2021.

[186] This was initially clarified in an agency regulation entitled "Fiduciary Requirements for Disclosure in Participant-Direct Individual account Plans" 73 FR 43014-01 (2008) and then codified in 29 C.F.R. § 2550.404c-1(d)(2)(iv) with the words that a participant's exercise of independent control over his assets in accordance with § 404(c) "does not serve to relieve a fiduciary from its duty to prudently select and monitor any service provider or designated investment alternative offered under the plan."

[187] LEE T. POLK, J.D. 1A ERISA PRACTICE AND LITIGATION § 6:14 (Dec. 2020) ("To "reiterate its long held position," the agency codified its position in the body of a new regulation. Now DOL's position is reflected in 29 C.F.R. § 2550.404c-1(d)(2)(iv) with the words that a participant's exercise of independent control over his assets in accordance with § 404(c) "does not serve to relieve a fiduciary from its duty to prudently select and monitor any service provider or designated investment alternative offered under the plan.")

[188] Mercer Bullard, *The Social Costs of Choice, Free Market Ideology and the Empirical Consequences*, 20 CONN. L. INS. J. 335, 335, 340

not liable as long as they took the steps required to avail themselves of 404(c), namely offering enough options, enough choice, and sufficient investor education.[189]

1. Expand the 404(c) Safe Harbor to Shield Fiduciaries from ESG-related Liability

One simple type of safe harbor that the Department of Labor could set up to encourage fiduciaries to offer an ESG option would be to simply amend the 404(c) safe harbor to include protections for a fiduciary's decision to include an ESG option. This could be done in one of two ways.

First, the Department of Labor could retract their prior regulation stating that 404(c) does *not* apply to plan investment selection, and instead adopt the position taken by the Third, Seventh, and Eighth Circuits that it *does* protect decisions at the plan level. The problem with this broad expansion of the safe harbor, however, is that it may end up protecting plan investment decisions that the Labor Department does not want to protect, such as choosing investment options that have excessive fees. It is not targeted specifically at including ESG options, so this broad safe harbor may do more harm than good.

A narrower expansion of the 404(c) safe harbor could specifically only extend the safe harbor to the decision to include an ESG option. The 404(c) regulation could be rewritten to state that this safe harbor does not extend to any decision made at the plan investment selection phase, *except for* the decision to add a prudently selected ESG plan. This would still require that the ESG investment be prudently selected, and would not shield the fiduciary from liability for picking a "bad" ESG investment. It would, however, shield a fiduciary from liability if they followed the steps to pick a prudent ESG investment (detailed above in the duty of prudence section), and then for whatever reason the investment did not perform as expected, and the participant wanted to sue to recoup losses.

This narrow expansion of the 404(c) large menu defense safe harbor to protect a fiduciary's decision to include an ESG option would lower the compliance costs of including ESG, and would be expected to lead to more ESG investments getting added to retirement plan lineups. Fiduciaries would just need to follow the 404(c) instructions and then could rest assured they would be protected in case of plan losses down the line. If a plan provides a broad menu of options, one of which is a prudently selected ESG investment option, a fiduciary could raise a complete 404(c) defense to a beneficiary suing for plan losses they claimed were due to the fiduciary's categorical selection of an ESG option. If beneficiaries could no longer sue a fiduciary for simply choosing an ESG option, fiduciaries would be encouraged, or at least not *discouraged*, to include an ESG option in their plan lineup.

2. Draft a New Safe Harbor Explicitly for ESG Investment Options

An alternative to expanding the 404(c) safe harbor defense to include the plan selection of an ESG investment could be to draft an entirely new safe harbor that applies only to ESG investments. This might be a more desirable approach for the Department of Labor to take, rather than just expanding 404(c) protection to ESG investments, since an ESG-specific safe harbor could be drafted in a way that takes ESG-specific investing into consideration. For example, the safe harbor could include specific process requirements that the fiduciary would need to do upfront in order to qualify for the safe harbor and remove the risk of litigation. There might be a requirement that the ESG fund have a certain number of years of outperformance of a non-ESG

[189] *Id.* at 339-340.

benchmark, to prove that the choice of this fund is in the sole economic interest of the beneficiary, and that the beneficiary's assets would not be taking a hit relative to how they'd perform in a non-ESG fund. Also, it could put certain limitations on the type of ESG investments that could be included, perhaps only allowing a safe harbor for ESG funds that are actively managed, rather than passively managed, since ESG investment research seems to indicate that actively managed ESG funds perform better than passively managed ESG funds.[190]

The problem with the Department of Labor creating a prescriptive safe harbor for certain types of ESG investment process choices is that it assumes that the Department of Labor is in a better position to mandate the requirements for a good ESG fund better than the fiduciary himself. Creating a rule where the Department of Labor, rather than the fiduciary, sets the process and parameters for which ESG funds are eligible for inclusion in the safe harbor not only presumes the agency knows better than the fiduciary, but it also risks becoming an inflexible regulation that is set in stone in the Federal Register. This safe harbor could become too difficult to change and update as the investment research changes and certain ESG strategies end up performing better than others. It also continues the differential treatment of ESG funds, which could stigmatize them.

While this kind of detailed and prescriptive safe harbor may give the Department of Labor an illusion of control and feelings of certainty that only "safe" ESG investments will qualify for protection under the safe harbor, this approach does risk becoming antiquated and resistant to change, as the updating and amending of rules takes agency attention, time, and coordination.

Ultimately, there are pros and cons for each approach the Department of Labor could take when updating the ESG Rule. This article sets out the argument in favor of updating the ESG Rule to encourage employers to offer ESG options in their lineups, and sets out a number of recommendations for the agency's consideration. The Department of Labor could completely rewrite the rule, amend pre-existing safe harbors, or draft a new safe harbor. The need for a regulatory change is clear, but various paths are plausible.

C. Work in Tandem with Other Government Agencies

No matter which path the Department of Labor chooses to follow, it would be a good idea for the Labor Department to work hand-in-hand with other agencies attending to ESG regulation. In particular, the Department of Labor should work with the Securities and Exchange Commission, which has also recently stated their intent to regulate heavily in the area of ESG.

The current SEC, which is technically an independent agency[191] but has a chairperson appointed by the President,[192] has made multiple moves early in the Biden Administration to

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[190]Tom Lyndon, *Is Active Management ESG More Comprehensive*, ETF Database (Dec. 8, 2020), https://etfdb.com/active-etf-channel/is-active-management-esg-more-comprehensive/ ("Over rolling one- and three-year periods since 1999, active ESG strategies beat their passive counterparts after fees more than 60% of the time across capitalizations and geographies. The success of active management was particularly pronounced in global and non-U.S. equity portfolios, as active outperformed passive at least 70% of the time").

[191] Mary Jo White, Chair, U.S. Securities and Exchange Commission, Speech at the 14th Annual A.A. Sommer, Jr. Corporate Securities and Financial Law Lecture, Fordham Law School: The Importance of Independence (Oct. 3, 2013), https://www.sec.gov/news/speech/spch100113mjw.

[192] Svea Herbst-Bayliss et al, *Biden to Name Gary Gensler as U.S. SEC Chair, Sources Say*, REUTERS (Jan. 12 ,2021), https://www.reuters.com/article/us-usa-biden-sec-exclusive/biden-to-name-gary-gensler-as-u-s-sec-chair-sources-say-idUSKBN29H2PQ.

signal its desire to push for sustainable investing. In early March of 2021, the SEC created a new Climate and ESG Task Force[193] and throughout the late winter and early spring, filled up its ranks with environmentally-conscious new leaders.[194] These moves signal an enhanced focus on regulating corporations' environmental impacts.[195] Specifically, the SEC intends to standardize ESG disclosures so that investors can accurately assess and value corporate exposure to climate change.[196]

The current lack of standardized disclosures makes it difficult for investors and consumers to truly understand the environmental impact a company has, or the company's exposure to climate change risks.[197] It also allows some companies to engage in "greenwashing," where they make their environmental impact look more positive than it really is by manipulating what metrics they are using to report ESG impacts.[198] Uncertainty about the extent or comprehensiveness of a company's ESG disclosures makes it difficult for investors to trust they are getting the full picture of a company's ESG exposure or impact. More than half of the respondents to a BlackRock survey cited concerns about "poor quality or availability of ESG data and analytics" as the biggest barrier to engaging in sustainable investing.[199]

Standardized and mandatory ESG disclosures will give investors a better understanding of how companies really stack up with their climate change risk and ESG impact. Robust disclosures will allow ESG investors to better select which companies truly belong in an ESG fund. This increased disclosure and proper valuation of risk and impact will allow employees to better trust that their assets will be safe in an ESG fund. The SEC and the Labor Department should coordinate their efforts to achieve maximum impact, by allowing for proper valuation of climate risk, minimizing greenwashing, and encouraging the investment of retirement plan assets in sustainable businesses.

CONCLUSION

The Department of Labor's most recent anti-ESG ESG Rule stands in the way of consumer demand for access to sustainable investments. It is the number one, if not only, barrier

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[193] Alexandra N. Farmer et al, *Enforcement Task Force Announcement is Latest Sign of SEC Focus on ESG and* Climate, Kirkland Ellis: Kirkland Alert (Mar. 8, 2021), https://www.kirkland.com/publications/kirkland-alert/2021/03/sec-climate-and-esg-task-force.

[194] Press Release, U.S. Securities and Exchange Commission, Satyam Khanna Named Senior Policy Advisor for Climate and ESG (Feb. 1, 2021), https://www.sec.gov/news/press-release/2021-20; Andrew Ramonas, *ESG Reporting Top Priority for SEC Director on Leave from Harvard,* Bloomberg Tax (Feb. 24, 2021), https://news.bloombergtax.com/financial-accounting/esg-reporting-top-priority-for-sec-director-on-leave-from-harvard.

[195] Mark Schoeff Jr., *Gensler Quizzed on Climate Disclosure, Mandatory Arbitration in Confirmation Hearing,* INVESTMENTNEWS (Mar. 2, 2021), https://www.investmentnews.com/gensler-quizzed-on-climate-disclosure-mandatory-arbitration-in-confirmation-hearing-203419.

Andrew Ramonas, *ESG Reporting Top Priority for SEC Director on Leave from Harvard,* Bloomberg Tax (Feb. 24, 2021), https://news.bloombergtax.com/financial-accounting/esg-reporting-top-priority-for-sec-director-on-leave-from-harvard.

[197] Dana Brakman Reiser & Anne Tucker, *Buyer Beware: Variation and Opacity in ESG and ESG Index Funds,* 41 CARDOZO L. REV. 1921 (2020)

[198] https://finance.yahoo.com/news/portfolio-warming-climate-anxiety-fund-100032539.html.

[199] Press Release, BlackRock, BlackRock Survey Shows Acceleration of Sustainable Investing (Dec. 3, 2020), https://www.blackrock.com/corporate/newsroom/press-releases/article/corporate-one/press-releases/blackrock-survey-shows-acceleration-of-sustainable-investing.

to Americans investing their retirement assets in greener, cleaner investment options that align with their values.

This article argues that a simple regulatory change will have significant impacts on retirement savings and sustainable investments *at the margin*. But saving and investing *at the margin* still matters. Given the nature of compound interest, if a 28-year-old millennial employee ends up saving an additional $100/month, pre-tax, because of a desirable investment option in her retirement account, that additional savings will compound to an additional ***$399,447.78*** at retirement, if she retires at 65 and we assume an annual return of 10%. Marginal regulatory changes with marginal impacts on retirement savings behavior have outsized impacts on retirement security.