RESPONSIBLE INVESTING

The DOL regulation and ESG innovation nexus

By: John Streur | November 3, 2020

Washington - The new rule from the Department of Labor regarding retirement plan fiduciaries regulated by the Employee Retirement Income Security Act (ERISA) regarding ESG investing requires that fiduciaries "must never sacrifice investment returns, take on additional investment risk, or pay higher fees to promote non-pecuniary benefits or goals." The marketplace is already driving major developments in ESG investing, and the new rule will not slow the positive momentum.

Investors around the world continue to direct capital to sustainable and responsible investment strategies. Demand in the United States has been entirely market-driven and U.S. regulators have not been a factor. Introduced into this fast-growing, disruptive and innovative industry, the new rule from the DOL on ESG investing may accelerate the growth across segments. We already have competition among global investment firms for ESG mandates; this will simply raise the bar in the United States. As a result, the pace of innovation that drives increased product quality will accelerate further, investor choice will increase and market impact will become greater. Give us a rule or a standard and we will seek to exceed it.

However, the rule will need further clarification. On the top of my list: agreeing on the correct interpretation of "non-pecuniary." Here, we see a direct link to "financial materiality," as used by Calvert and organizations like the Sustainability Accounting Standards Board (SASB).

It is not so much the rule that is interesting, it is the potential market-driven response to the rule. The phrasing grounded in "non-pecuniary" may create an adverse perception of the rule, but the implications are not necessarily bad for responsible investors. (We have said, "if an ESG issue matters to relevant investment outcomes, consider it." The DOL seems to prefer to say, "if an issue doesn't matter, don't consider it." Is it possible we are all saying the same thing?)

Focus on financial outcomes

From our perspective, performance already is — and should remain — the priority. Increasingly, issuers of securities are expected to properly manage ESG risks within the context of an enterprise risk management (ERM) process as a minimum hurdle. Many are now competing on performance to enhance the brand and to improve product quality and operational performance. I believe that in the context of the DOL rule, the "non-pecuniary" passage reflects what we term financial materiality. We consider the impact of financially material ESG issues when evaluating investments and creating our investment strategies. In fact, financial materiality is the bedrock upon which we built the Calvert Research System. Connecting ESG exposures to potential financial outcomes is a key focus of our research.

The rule places a very strong emphasis on the point that investments in ERISA plans must place the attainment of the plan investment needs at the forefront of all actions. This is nothing new. It is the foundation of ERISA. The rule uses the term "non-pecuniary" to describe the type of considerations it seeks to prohibit; there is a history of the use of this concept by the DOL as it manages the ERISA framework. Again, nothing new, at a high level. Investment managers competing for this business are already in a market-driven, competitive trajectory and now have a DOL benchmark to meet or beat. This requires a strong and disciplined process to analyze the ESG performance of an investment and the potential impact on financial and investment outcomes. This process must include financially material ESG information from companies, disclosed under the SASB and Taskforce on Climate-related Financial Disclosures (TCFD) frameworks. The new rule will drive additional investor demand for transparency, disclosure, measurement and improvement on relevant ESG performance metrics from issuers of securities.

The sustainable and responsible investment management community has already undertaken the work necessary to create the processes to supply the metrics and the data necessary to meet the DOL's requirements. In addition to SASB, the Impact Weighted Accounts Initiative framework will also be helpful in proving the financial materiality of specific ESG (primarily E and S) factors. This rule may be seen as consistent with major workstreams going on around the world that build market ESG infrastructure and move the analysis of an issuer of securities' ESG exposure, actual impact and relevant financial implications further and faster into the mainstream.

As an investor who wants to contribute to positive change, we recognize that if we can't drive positive change that works for all stakeholders, including those who focus narrowly on financial outcomes, the system won't perform optimally. The DOL is raising the bar, but to an attainable level. The rule may also help to make clients comfortable with the concept of ESG investments, as the new rule may be used to present a standard or quality bar to measure against.

The way forward

Nobody likes to be subject to additional rules, and nobody likes to be told what to do, but generally I think this is a better rule than the originally proposed version, perhaps because of the 8,700 comment letters received by the DOL. Specifically, it removed the QDIA language, which will clear the way for competition among ESG asset managers.

Bottom line: The DOL rule presents the potential for clarity around the need to incorporate financially material issues, including those related to ESG, into investment decision making. It sets an appropriate burden on investment management organizations to focus on financial materiality when meeting ERISA client interest in ESG-oriented products. The market response may hasten the development of the conditions necessary to drive positive change at corporations we invest in, and to push ESG investing forward. Yes, no one likes new and more rules, but we need to accept these burdens along with the benefits such as trust and confidence our system of rules and regulations ultimately creates.

When new rules are created, legal costs and litigation risk rise for subject companies. That will occur when this rule becomes effective. To be clear, we view this as a part of our legal and regulatory system, and not something that is unique or necessarily excessive in the case of this new rule. With that in mind, Calvert is not displeased with the newly-worded rule.

Picture of John Streur

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