NEWS ANALYSIS

ESG in Your 401(k) Account?

by Lee A. Sheppard

Jeff Beck was a musician's musician.

Born in Surrey, England, like his contemporaries Jimmy Page and Eric Clapton, Beck was a virtuoso of the electric guitar. Playing without a pick, he could coax swirling cirrus clouds of sounds out of the instrument that none of his peers could achieve. He died earlier this month at age 78 of bacterial meningitis, which is rare and frequently misdiagnosed. His death inspired encomia from fellow guitarists that were longer and more detailed than the "miss you, man" tweets that usually greet the passing of one of their number.

"The six stringed Warrior is no longer here for us to admire the spell he could weave around our mortal emotions. Jeff could channel music from the ethereal," Page, his lifelong friend, commented.

"I couldn't believe how incredible he was, not only with his technique but his sound too. I became a fan of his ever since. He could reach up into the stars and make magic with his playing. His choice of notes were always absolutely perfect," Ritchie Blackmore said.

Beck was self-taught and met Page in art school. His talent was recognized early. He joined the Yardbirds — a revolving door of England's best talent — in 1965, age 21, replacing Clapton at Page's recommendation. Beck moved the Yardbirds toward a psychedelic sound. Tossed out of the band for missing gigs, he formed his own band with Rod Stewart and Ronnie Wood. After Brian Jones drowned, he was invited to join the Rolling Stones, who were well on their way from bar band to worldwide brand. Beck might be the only musician ever to refuse such an offer. On his way to England, Jimi Hendrix wanted to meet him.

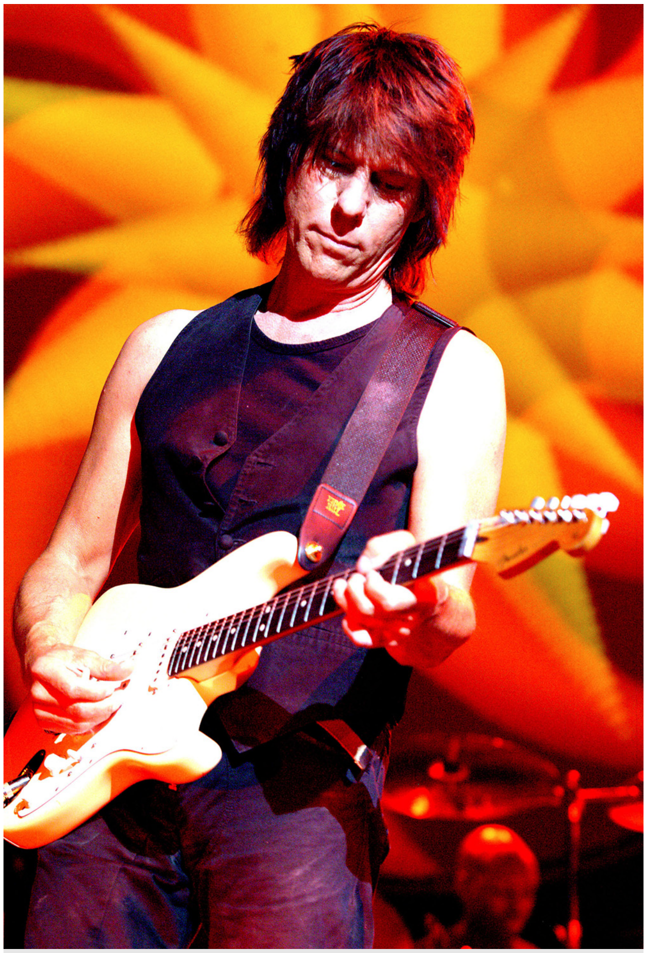
Beck never became a household name and doesn't seem to have been bothered by it. The quintessential loner, he never stayed in a band long. Most of his signature pieces were instrumentals. He didn't like singers at all. OK, all band members hate their singers, but Beck found them more of an irritation than an addition. Nonetheless, Stewart called him the only guitarist who listened to what he was doing.

Beck's death, along with that of Peter Green, marks the beginning of the end of an era. The 1970s were the golden era of rock, never to be repeated. Beck was the last of a breed inspired by influences going beyond other people's rock music. Put it this way: The reason a lot of '80s rock music sounds derivative is because its creators never listened to anything but rock music, failing to understand that their '70s heroes had influences ranging from rhythm and blues to western swing to jazz to classical. What is now called rockabilly, in the persons of Gene Vincent and Buddy Holly, was a big influence on Beck.

His last performances saw him playing with Johnny Depp, who, when he isn't wrecking his financial life, fancies himself a rock guitarist. Depp personally bankrolls the Hollywood Vampires, his vanity project with Alice Cooper and Joe Perry, but he had a genuine friendship with Beck and visited his bedside when he was dying. The Beck-Depp album *18* will be released July 15.

Beck lived a quiet life in the English countryside, where he built hot rods and supported wildlife charities. Musicians who live on the road can have trouble sustaining a middle class lifestyle. They may be unable to live within their means or may have unscrupulous managers. Saving for retirement, or even having one, is a foreign concept. Our readers are in the opposite position. They aggressively save their money, often through employer-sponsored plans. Now these responsible citizens are being told that climate change is more important than their retirement.

Some financial commentators are frothing about a Biden administration rule that they say would require investments held by pension funds and offered in section 401(k) plan menus to take



Jeff Beck could create ethereal sounds that no one else could achieve. (HW2/Danny Clifford/Hottwire.net/WENN/Newscom)

environmental, social, and governance (ESG) factors of issuers into account in investment decisions. The Labor Department Employee Benefits Security Administration (EBSA) regulation, which is final, goes into effect at the end of January. Would it really do what the critics say? No. While it wouldn't stop fiduciaries and fund managers that are determined to incorporate ESG, it wouldn't offer them any more legal protection than they previously had.

Individual account plans can offer ESG investments, and participants choose funds from a menu, so what's the problem? We're way beyond just offering explicit ESG investments on a section 401(k) investment menu. Many plan participants don't choose their own investments. They automatically enrolled in default investments or choose target date funds of unknown composition. The same would hold for the portfolio underlying a defined benefits plan, which hardly exists in the private sector anymore. ESG could come into plans by fiduciary choosing, not participant choice.

Retirement plans hold a very large proportion of publicly traded shares. This rule could have the effect of directing that large swath of retirement plan capital toward issuers that are ESG compliant. The Biden administration is trying to mobilize private parties to do what the executive branch lacks the authority to do. And it is also using public resources. Retirement plan money is tax-subsidized (section 401).

The new rule is part of a whole-of-government effort. The SEC has no authority to compel publicly traded companies to make climate disclosures that cannot be measured or audited (SEC Release 33-11042, 87 F.R. 21334 (Mar. 21, 2022)). Nor do bank regulators have the power to tell banks not to lend to disfavored industries (Docket ID OCC-2021-0023, OCC Bulletin 2021-62 (Dec. 16, 2021)). All those rules will be challenged in federal court. The Supreme Court has made it clear that environmental concerns do not justify extrastatutory power grabs (*West Virginia v. EPA*, No. 20-1530 (June 30, 2022)).

Meanwhile, Jamie Dimon of JPMorgan Chase made it clear that his bank would continue to lend to oil drillers. Brian Moynihan of Bank of America echoed that commitment.

> ***This rule could have the effect of directing that large swath of retirement plan capital toward issuers that are ESG compliant.***

Dimon didn't deal the only blow to ESG. Vanguard — the world's second largest asset manager after BlackRock — recently quit the Net Zero Asset Managers initiative, which supports net zero greenhouse gas emissions by 2030.

The initiative requires its members to prescribe specific emissions targets for industry sectors (that is, utilities). Vanguard noted that it's unclear what effect the initiative would have on index funds — which Vanguard pioneered and are hugely popular with investors large and small. Vanguard, which manages $7 trillion, will still sell specifically identified ESG funds to investors who want them. Oh, and 13 state attorneys general (ultimately in charge of investing state pension assets) are suing Vanguard for breaking its promise to manage utility investments passively.

BlackRock, which manages $10 trillion, is particularly active and aggressive about ESG, is a member of the initiative, as are J.P. Morgan Asset Management, T. Rowe Price, and State Street. Fidelity, Charles Schwab, and PIMCO are not members. Several state pension funds have withdrawn investments from BlackRock, and others are making noises to that effect. Ten states have restricted the use of ESG factors in investment choices for their state retirement plans. Net zero is supposed to refer to carbon emissions, not investment returns.

Last year, Florida withdrew $2 billion from BlackRock, with the state's CFO criticizing the firm for having goals other than producing investment returns. The trustees of the state pension plan changed their policy so that investment decisions "must be based only on pecuniary factors" which do not take into account "social, political, or ideological interests." BlackRock, which manages $30 billion of the state's $220 billion in pension money, committed to follow the terms (Bloomberg, Jan. 19, 2023).

The Texas Senate subpoenaed BlackRock demanding data on ESG integration into pension management. At the subsequent public hearing, Dalia Blass, BlackRock's head of external affairs, a former Biden SEC official, admitted that the firm wasn't divesting, but trying to change behavior for an orderly transition, and that ESG was just a form of risk management. This admission might have prompted the New York City comptroller's threat to reassess his $43 billion part of the municipal pension system's relationship with BlackRock for not doing enough to divest from fossil fuels.

Here's your speed read: If the net zero asset management behemoth that runs your plan wants ESG investments, your plan will have ESG investments. But if it damages your investment returns, you still may be able to sue them for it.

Background

ESG and other noneconomic goals have been creeping into retirement plans for years.

On his first day in office, President Biden signed an executive order requiring a whole-of-government approach to ESG (Executive Order 13990, 86 F.R. 7037 (Jan. 25, 2021)). This was followed five months later by a second executive order requiring mitigation of climate-related financial risk, including an instruction to Labor to protect retirement savings from climate risk (Executive Order 14030, 86 F.R. 27967 (May 25, 2021)).

ERISA is paternalistic in a good way. ERISA says that a plan is to be operated for the exclusive purpose of providing benefits to participants (29 U.S.C. section 1104(a)(1)(A)). ERISA incorporates the common law of trusts, specifically the fiduciary duties of prudence and loyalty. Of the two concepts, prudence is more important. Plan sponsors and fiduciaries are not allowed to draft out of these duties.

> ***ESG and other noneconomic goals have been creeping into retirement plans for years.***

A fiduciary has a duty of loyalty to plan participants (29 U.S.C. sections 1103, 1104). The prudence rule states that a fiduciary must act with the "care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims" (29 U.S.C. section 1104(a)(1)(B)). The effect of these duties on investment choices is spelled out in the EBSA investment duties regulation — the regulation that was rewritten (29 C.F.R. part 2550.404a-1).

The same investment duties rules apply to defined benefit, defined contribution, and section 401(k) individual account plans. The rules are traditionally written for pension plan portfolios, but have been clumsily adapted to section 401(k) plan investment choice menus, the latter having become the dominant employer-sponsored retirement plans.

EBSA has a long history of informal guidance tiptoeing around allowing noneconomic investments. EBSA issued numerous advisory opinions and information letters dating back 40 years granting prohibited transaction exemptions for social investments. Yes, union pension plans were allowed to make construction loans (how did that work out?). Then in 1994, EBSA said collateral benefits apart from investment return could be taken into account, provided the investment offers returns commensurate to the alternatives. The Clinton administration used it to justify projects that would create union jobs (Interpretive Bulletin 94-1, 59 F.R. 32606 (June 23, 1994)).

EBSA said an investment is permitted if a fiduciary prudently determines that it is appropriate based solely on economic considerations, including ESG factors (Interpretive Bulletin 2015-01, 80 F.R. 65135 (Oct. 26, 2015)). But then EBSA clarified that asset managers were prudent in worrying about ESG risks if management of the issuer saw those risks as material business risks. Fiduciaries should weigh ESG factors and shouldn't rush to treat them as economically relevant. Fiduciaries should put the economic interests of the plan first. ESG investments can be included in a menu of participant investment options in a section 401(k) plan. But an ESG investment cannot be a default investment because that would violate the duty of loyalty. An ESG target date fund offering lower returns or more risk than the alternative cannot be the default option (Field Assistance Bulletin 2018-01 (Apr. 23, 2018)).

The informal guidance was on a slippery slope toward permitting noneconomic investments. Fiduciaries wondered whether there was a conflict with their duty of loyalty or prudence, that is, whether they might be sued for using ESG in making investment choices. Asset managers making ESG investments have tried to protect themselves by arguing that ESG is a proactive risk management tool that will ultimately produce higher returns or avoid losses from factors like pollution taxes or stranded assets.

The May 2021 executive order specifically directed Labor to reverse a Trump administration rule. The Trump rule explicitly said fiduciaries can consider only pecuniary factors affecting risk and returns when choosing investments (85 F.R. 72846 (Nov. 13, 2020)). Competing investments must be economically indistinguishable on pecuniary factors before any non-pecuniary factors such as ESG can be brought into the analysis, and the decision must be documented (prior 29 C.F.R. section 2550.404a-1(c)(2)). That regulation prohibited adding or retaining any investment or fund as a default alternative if it had even a single non-pecuniary objective (prior 29 C.F.R. section 2550.404a-1(d)(2)(ii)).

The word "pecuniary" came from a 2014 Supreme Court decision on the prudence standard. The Court held that the special ESOP exception to the diversification rule did not protect a fiduciary from the prudence rule. The Court further held there is no presumption of prudence for fiduciary actions. The duty of prudence does not vary depending on the specific nonpecuniary goals of the plan, Justice Breyer wrote for the unanimous Court (*Fifth Third Bancorp v. Dudenhoeffer*, 573 U.S. 409 (2014)).

Breyer wrote:

> Read in the context of ERISA as a whole, the term "benefits" in the provision just quoted must be understood to refer to the sort of *financial* benefits (such as retirement income) that trustees who manage investments typically seek to secure for the trust's beneficiaries. The term does not cover nonpecuniary benefits like those supposed to arise from employee ownership of employer stock. [Emphasis in original.]

Fifth Third's defined contribution plan allowed participants to choose among investments, while employer contributions were initially invested in an ESOP. The fiduciary (the bank itself) continued to purchase employer shares for the ESOP just before the share price collapsed in the 2008 meltdown. Participants argued that the fiduciary should have stopped purchases, sold shares, canceled the ESOP, and publicized what it knew about the bank's condition. But the participants failed to allege an alternative action that would have been legal and prudent.

The *Dudenhoeffer* decision should have put paid to all consideration of nonpecuniary motives in plan investments, but it didn't. The impetus for the Trump rule was to prevent investment screening against oil companies. The Biden administration viewed that rule as subjecting ESG investing to heightened scrutiny and having a chilling effect on ESG investing. So the Biden administration deleted the pecuniary thresholds in its October 2021 proposed version of the new ESG rule.

The proposed ESG regulation treated ESG and climate change as economic factors. It would have effectively told fiduciaries to take ESG into account in making investment decisions, by stating that plan goals "may often require an evaluation of the economic effects of climate change and other environmental, social or governance factors on the particular investment or investment course of action." The phrase "may often require" provoked a firestorm. Commentators howled that it would have imposed a de facto ESG mandate. Importantly, the rule prohibiting ESG in default investment choices was removed. The proposed rule would have allowed ESG to be invoked as a tiebreaker when competing investments were evaluated on a long time horizon, as long as it was prominently disclosed (86 F.R. 57272 (Oct. 14, 2021)).

Ironically, the principal economic environmental threat to some issuers would be the potential for environmental taxes and regulation from the Biden administration and a Democratic Congress. But ESG is not defined either in the proposed regulation or the final regulation. The preamble to the final rule, which has no legal effect, has examples of ESG factors. ESG seems to mean whatever a fiduciary wants it to mean. So we're looking at fiduciary consideration of an undefined noneconomic factor in investment decisions. Why wouldn't that violate the statutory prudence and loyalty requirements *ab initio*?

Because ERISA incorporated the common law of trusts, its statutory duties can be interpreted using trust precedent (*Central States, Southeast & Southwest Areas Pension Fund v. Central Transport Inc.*, 472 U.S. 559 (1985)). Fiduciaries are not supposed to do stupid or venal things that harm plan participants. A plan fiduciary told participants their benefits would be assured to persuade them to withdraw from their old benefits plan and switch over to a new plan of an insolvent subsidiary, which promptly went into receivership. The Supreme Court held that the fiduciary had deliberately deceived the participants and that lying is inconsistent with the duty of loyalty (*Varity v. Howe*, 516 U.S. 489 (1996)).

The New Rule

Under the new rule, a fiduciary may not be disloyal for making ESG investments, but it could be imprudent.

The new final rule is not as exciting as the proposed rule, and it adheres to ERISA prudence standards. It's a huge climbdown from the proposed rule. It doesn't offer fiduciaries any more protection on ESG investments than they already have under the prudence rule. It might actually disappoint climate activists.

The new final regulation, like the proposed version, removed the requirement that investments be evaluated on pecuniary returns alone. It withdrew the controversial "may often require" language and replaced it with vague instructions that a fiduciary may evaluate investments based on risk factors including the economic effects of ESG factors and climate change. The proposed rule contained three ESG examples that were removed in the final version lest they be interpreted as a safe harbor (EBSA-2021-0013-4053).

The "may often require" phrasing was replaced with a vague, principles-based instruction that risk and return factors may include ESG and climate change, with appropriate weighting.

Here is the prudence test of the new final rule (29 C.F.R. section 2550.404a-1(b)(4)):

> A fiduciary's determination with respect to an investment or investment course of action must be based on factors that the fiduciary reasonably determines are relevant to a risk and return analysis, using appropriate investment horizons consistent with the plan's investment objectives and taking into account the funding policy of the plan established pursuant to section 402(b)(1) of ERISA. Risk and return factors may include the economic effects of climate change and

> other environmental, social, or governance factors on the particular investment or investment course of action. Whether any particular consideration is a risk-return factor depends on the individual facts and circumstances. The weight given to any factor by a fiduciary should appropriately reflect a reasonable assessment of its impact on risk-return.

The first sentence is restatement of the prudent man rule. The second sentence, stating that risk factors may include ESG, is new. The third and fourth sentences warn fiduciaries that these risks are fact-specific and should be weighed.

In the loyalty discussion, the new rule states (29 C.F.R. section 2550.404a-1(c)(1)):

> A fiduciary may not subordinate the interests of the participants and beneficiaries in their retirement income or financial benefits under the plan to other objectives, and may not sacrifice investment return or take on additional investment risk to promote benefits or goals unrelated to interests of the participants and beneficiaries in their retirement income or financial benefits under the plan.

As to coping with ESG, fiduciaries are on their own, and EBSA admits as much in the preamble. "A fiduciary therefore remains free under the final rule to determine that an ESG-focused investment is *not* in fact prudent" (emphasis in original), the preamble states. A fiduciary can use ESG as a tiebreaker to decide between competing investments, provided they are indistinguishable. "A fiduciary may not, however, accept expected reduced returns or greater risks to secure such additional benefits," the rule states (29 C.F.R. section 2550.404a-1(c)(2)). There is no special documentation requirement for these decisions, but documentation has long been recognized as best practice.

"Importantly, the final ESG rule retains the long-standing position of the Department that a fiduciary may not sacrifice investment return or accept additional investment risk in pursuit of collateral benefits or objectives unrelated to a participant's interest in their retirement income or financial benefits under the plan," said Preston Rutledge, former Assistant Secretary, Employee Benefits Security Administration, U.S. Department of Labor, who worked on the rescinded Trump rule.

The new rule may nonetheless succeed in channeling a fair amount of money into ESG investments as a practical matter. As in the proposed rule, the same standards apply to default choices in section 401(k) individual account plan menus. Default investments are often selected in automatic enrollment, which is a feature of many plans. Participants who are automatically enrolled or select target date funds are unlikely to be financially sophisticated or interested in detail. These investments are likely to be sticky because participants put into default options tend to stay with them.

What if your unsophisticated participants are a bunch of millennials and zoomers who demand green investment choices in their plan? The new rule allows a fiduciary to cater to their whims when building the investment choice menu without violating the duty of loyalty, provided that the fiduciary chose prudent investments (20 C.F.R. section 2550.404a-1(c)(3)). The reasoning is that the kids will be more likely to participate and save. Maybe they'll sue over poor returns from their ESG investment choices when they grow up. ERISA authorizes equitable relief for aggrieved plan participants (*Massachusetts Mutual Life Ins. Co. v. Russell*, 473 U.S. 134 (1985)).

By now readers may wonder whether successive administrations will flip-flop on ESG investing in retirement plans. Absolutely that will happen. And every time a new administration rescinds a previous administration's rule, it has to justify that action with reasoned decision-making under the Administrative Procedure Act (5 U.S.C. sections 551 et seq.). A regulator must "articulate a satisfactory explanation for its action including a rational connection between the facts found and the choice made" (*Encino Motorcars LLC v. Navarro*, 579 U.S. 211 (2016)).

So everyone marches off to court to argue about that procedural step in addition to the substance of the rule. EBSA's justification for the reversal was the executive order demanding that it rescind the pecuniary rule. Is that sufficient as a reasoned explanation? When faced with executive orders, agencies strive to comply with them while staying within the contours of the statute.

But there are procedural hurdles. A regulation has to satisfy a cost/benefit regulatory impact analysis. When the regulation being repealed hasn't been in force long enough for anyone to evaluate its costs — as is the case for the Trump rule repealed here — how can the cost/benefit analysis be performed? Um, economic studies. EBSA argued that the new rule cleared up confusion and prejudice about ESG that could negatively affect plan financial performance, while costs would not be high because so much settled law and regulatory language are preserved. Weirdly, EBSA estimated that only about 20 percent of all plans would be affected by the final rule, based on private estimates of how many plans have adopted ESG investing. ■

NEWS ANALYSIS

The Great Debt Ceiling Showdown of 2023

by Martin A. Sullivan

Once the November 2022 election results were tallied, the stage was set for a debt ceiling showdown in 2023. History tells us that with the combination of a Democrat in the White House and Republicans in control of the House of Representatives, conditions are ripe for a knock-down, drag-out fight over federal finances.

> ***What will happen when a dedicated group of newly empowered firebrands have the power to block a vital increase in the debt ceiling?***

That's bad, but it gets worse. The makeup of the newly elected Congress tells us the 2023 debt limit showdown could easily be the most contentious ever. After all, it took five days and 15 votes for a Republican Congress to complete the routine task of electing a Republican speaker who, by the way, had no Republican opponent. What will happen when a dedicated group of newly empowered firebrands have the power to block a vital increase in the debt ceiling? It's hard to see how we avoid legislative turmoil with potentially large economic effects.

Here We Go Again

The statutory limit on outstanding debt was created by Congress during World War I. Since 1990, almost every Congress has increased or suspended the debt limit once or twice. That legislation often passes without a struggle that makes it to the front page. But when Democrats and Republicans dig in their heels, the conflict can take center stage.

Here's how these unpleasant and uniquely American episodes unfold. When the spiraling federal debt tippy-toes up to the formal statutory limit on the level of outstanding federal debt, the Treasury secretary tells Congress that the department must engage in "extraordinary measures" to pay the bills without technically increasing its indebtedness. One example of an extraordinary measure is delaying (until after the