Responsible for What? The EU-United States Divide on Responsible Investment

Responsible investment is a difficult term to pin down. At AIMA, we have argued that the best way to understand it is to think about it in terms of goals: an investor's objective will shape the kind of responsible investment they pursue.[1] This is no less true when looking at entire jurisdictions.

The United States of America is often described as 'behind' the European Union when it comes to the adoption and regulation of responsible investment. This is, of course, partially driven by optics. At a time when environmental concerns are front-and-centre, the EU has announced ambitions to become a global environmental leader; the United States recently became the first country to leave the Paris Accords. The notion United States is a laggard is also predicated on the assumption that responsible investment means the same thing in the United States as it does in the EU. After all, you cannot be 'behind' someone if you are not going to the same place.

However, when we discuss responsible investment in the United States and the EU we are, at least for now, discussing two different phenomena, with two different goals. The EU has adopted a raft of policies to create a 'sustainable' economy: its responsible investment regulations are, in many ways, merely a means to this end. In the United States, however, responsible investment is generally seen only as a way to mitigate material investment risks; recent regulation has explicitly foreclosed the possibility of using it to affect the wider economy.

This paper will explore that difference. We will begin with an overview of the recent United States Department of Labor (DoL) rules for ERISA fiduciaries. We will use them as examples to highlight the fundamental difference between how the EU and United States understand responsible investment. Finally, we will briefly examine the implications of united Democrat control of the American federal government for the future of American responsible investment regulation.

ERISA Pension Schemes

The Employee Retirement Income Security Act of 1974, to use its full name, regulates the private, employer-sponsored retirement schemes in the United States of America—be they defined benefit or defined contribution in nature. ERISA sets minimum standards and defines fiduciary duties. Interestingly, while the Act does not cover public pension schemes (pension schemes sponsored by governments at the municipal, state, or federal level), it is not uncommon for public pension plans to make use of ERISA provisions, especially when dealing with third-party managers. ERISA, in short, covers all private pensions schemes in the United States, and affects a significant portion of the public ones, too.

For reference, the US dollar value of the combined assets of all funded[2] private and public pension schemes in the United States in 2019 was estimated at 18.8 trillion.[3]

1 For a full explanation, please see our Responsible Investment Primer: https://www.aima.org/resource/aima-responsible-investment-primer.html
2 Which is to say, those pension schemes that collect assets, as opposed to 'unfunded' schemes, which simply pass capital directly from those in the workforce to those who have retired.
3 https://www.oecd.org/pensions/Pension-Funds-in-Figures-2020.pdf

The DoL Rules, pt.1: pecuniary matters

The first DoL rule of interest, "Financial Factors in Selecting Plan Investments," was proposed by the DoL on the 30th of June; the comment period ran exactly one month, to the 30th of July. The finalised rule was adopted on the 30th of October. When it was proposed the stated goal of the rule was to remind pension scheme fiduciaries of their duties. Specifically, as originally proposed the rule would have clarified the circumstances in which 'ESG' factors could be considered by fiduciaries.

The proposed rule affirmed that pension scheme trustees must under no circumstance forego investment returns to pursue ESG goals, and noted that it is "unlawful for a fiduciary to sacrifice return or accept additional risk to promote a public policy, political, or any other non-pecuniary goal."[4] This, of course, is nothing new. Anyone with even a passing familiarity with ERISA knows that trustees cannot sacrifice fund performance for the sake of other goals. This is the rule that prevents a trustee from foregoing returns in order to invest in, say, rhinoceros bonds.

The key term in the proposed rule, however, was 'non-pecuniary.' In the original proposal, the DoL took the position that ESG factors are prima facie non-pecuniary. That is to say, the default assumption is that ESG factors are not financially material, and therefore cannot be considered when fiduciaries—or the firms to which they allocate—make investment decisions. The proposed rule even went so far as to ban the use of ESG factors in any qualified default investment alternative (QDIA).[5] [6]

To complicate matters, however, the DoL also acknowledged—in the same proposed rule—that ESG factors could be pecuniary. "Environmental, social, corporate governance, or other similarly oriented considerations are pecuniary factors only if they present economic risks or opportunities that qualified investment professionals would treat as material economic considerations under generally accepted investment theories."[7] In other words, ESG factors were assumed to be non-pecuniary, and thus could not be considered by fiduciaries. Unless, however, they were financially relevant, in which case they would be ipso facto pecuniary, and thus not only could be considered, but "must" be.[8] [9]

The DoL evidently received a fair amount of pushback on some elements of the proposed plan, including from AIMA and MFA.[10] Some respondents noted that the use of 'ESG' at all seemed to be singling such factors out for extra scrutiny, and might result in fiduciaries being deterred from considering such factors even if they had good reason to do so. Some respondents also highlighted the logical inconsistency of acknowledging that ESG factors can be financially material while simultaneously barring fiduciaries from considering them in QDIAs.[11]

In response, the DoL simply excised any mention of "ESG" in the final rule, and replaced it with "pecuniary" or "non-pecuniary." The final rule also affirms the ability of plan fiduciaries to offer investment products that consider non-pecuniary factors or goals, so long as those products meet their pecuniary targets first (the inclusion of non-pecuniary factors in QDIAs is still forbidden). Interestingly, the DoL acknowledges that the scope of pecuniary factors can be broad. For instance, the DoL notes that "if a fiduciary were to prudently conclude that a fund manager's brand or reputation will materially affect the expected risk and/or return as funds, then such factors would be pecuniary" (emphasis added).

4 https://www.federalregister.gov/d/2020-13705/p-54
5 "...the environmental, social, corporate governance, or similarly oriented investment mandate alternative is not added as, or as a component of, a qualified default investment alternative..."
6 A QDIA, to use the inevitable acronym, is the default fund to which a beneficiary's capital is allocated in a 401(k) plan, unless and until that beneficiary chooses to move their money.
7 https://www.federalregister.gov/documents/2020/06/30/2020-13705/financial-factors-in-selecting-plan-investments
8 https://www.federalregister.gov/documents/2020/06/30/2020-13705/financial-factors-in-selecting-plan-investments
9 Except, of course, in the case of QDIAs, in which case the consideration of ESG factors, pecuniary or not, were forbidden outright.
10 https://www.managedfunds.org/wp-content/uploads/2020/09/MFA-AIMA-Letter-on-DoL-ESG-Rules.pdf
11 Other respondents made note of the rather short comment period for the proposed rule: https://corpgov.law.harvard.edu/2020/08/26/comment-on-the-proposed-dol-rule-2/

The DoL Rules, pt.2: voting proxies

The second proposed DoL rule caused even more controversy. "Fiduciary Duties Regarding Proxy Voting and Shareholder Rights" was proposed on the 31st of October; the comment period was again a mere 30 days long. Taken together, the provisions of the proposed rule would have drastically limit the ability of ERISA fiduciaries to vote their proxies and exercise their shareholder rights.

Following the pattern set by the "Financial Factors" rule, the proposed rule began by reminding fiduciaries of their duty to focus on the performance of their plans. The proposal went on to state that proxy voting is becoming more complex, and that research on the benefits of voting has "yielded mixed results."[12] The proposal continued: "The [DoL] is now concerned that some fiduciaries and proxy advisory firms [...] may be acting in ways that unwittingly allow plan assets to be used to support or pursue proxy proposals for environmental, social, or public policy agendas that have no connection to increasing the value of investments used for the payment of benefits or plan administrative expenses, and in fact may have unnecessarily increased plan expenses" (emphasis added).[13 14]

To follow the DoL's logic, if exercising your shareholders rights is both expensive and of questionable value, it stands to reason that the circumstances in which you do so should be limited. In fact, according to the proposed rule, fiduciaries should only vote their proxies when they know that doing so will produce a financial benefit for their plans. "A plan fiduciary must not vote any proxy unless the fiduciary prudently determines that the matter being voted upon would have an economic impact on the plan."[15]

The proposed rule went on to offer examples of policies that fiduciaries could adopt for exercising their shareholder rights, in order to spare themselves from interrogating the potential effect of every issue on which they could vote:

1. A policy of voting in accordance with the recommendations of corporate management on issues that they deem unlikely to have a financial impact.[16]

2. A policy of only voting on issues likely to have a significant impact on the share price of a corporation (for instance, mergers and acquisitions).

3. A policy of refraining from voting in instances when fiduciaries deem their share of the company's equity too small to make a difference.

Clearly all three examples would represent a significant change in shareholder activism. The first option would seem to fly in the face of almost a century of investor behaviour, starting with Benjamin Graham's letter to the Northern Pipeline Company. The logic underpinning the third option, meanwhile, would seem to undercut the notion of voting in any context in which your vote was not by itself decisive.[17]

---

12 https://www.govinfo.gov/content/pkg/FR-2020-09-04/pdf/2020-19472.pdf
13 Ibid.
14 This line of thinking builds upon recent SEC scrutiny of proxy voting services, and the argument that fiduciaries need to put more effort—and thus, presumably, more resources—into determining how they vote their proxies. The proposed DoL rule prohibits fiduciaries from adopting a policy of automatically following the advice of proxy adviser services, thus presumably further increasing the cost of voting their proxies.
15 https://www.govinfo.gov/content/pkg/FR-2020-09-04/pdf/2020-19472.pdf
16 The logic being that they would be relying on the fiduciary duty those corporate officers owe to their corporation.
17 Fans of social theory might recognise this as running afoul of the 'paradox of collective action.'

Just as with the proposed rule on "Financial Factors," the DoL faced significant pushback over this proposed rule. Some argued that the proposed rule would dissuade pension scheme fiduciaries from exercising their shareholder rights except in the most clear-cut of cases, as they will be (justifiably) concerned of falling afoul of the rule. Others suggested that the proposed rule might actually harm the DoL's own stated objectives, as the enhanced scrutiny could lead to fiduciaries spending more on consultants and compliance experts in order to ensure that they strictly abide by the rule—a concern shared by AIMA and the MFA.[18]

In the face of these concerns, the DoL shifted the final rule away from a prescriptive approach, and towards a principles-based one. The final rule establishes a six-part rule fiduciaries should use to determine whether they should exercise their shareholder rights. Fiduciaries must only act in the economic interest of their plan, and must take any costs attached to exercising their rights into account. They must not subordinate the interests of their members to any non-pecuniary interests, and they must "evaluate the material facts" that form the basis of the exercise of their shareholder rights.[19] Finally, fiduciaries must maintain records on their shareholder activities, and act "act prudently and diligently" in selecting and monitoring proxy voting services.[20]

RI regulation in the United States

Taken together, the DoL rules have been interpreted in some corners as a bid to stifle the growth of responsible investment in the United States. This, however, is not entirely correct. Rather, the DoL proposals seem to be an attempt to pre-empt a specific understanding of responsible investment—specifically, the understanding of responsible investment being promoted in the EU.

The EU has set itself the goal of becoming a global leader in environmental sustainability. To that end, it has begun creating a regulatory framework to reorient private capital towards 'sustainable' investments, with the goal of reshaping the economy as a whole. This dynamic is best captured by the term 'principle adverse sustainability impact,' a new concept that will require certain investment managers to analyse and document the effects their investments have on the wider world. This is the essence of what the EU calls 'sustainable finance.'

The United States, meanwhile, seems intent on pursuing a more traditional understanding of responsible investment, in which investment managers take non-financial factors into account if and when those factors are financially material. The goal is to enhance risk-adjusted returns, tout court.

The current rules are, of course, products of the current administration, which has not made climate change a priority, and it remains to be seen how the Biden administration might change the paradigm. While the 'Green New Deal' would represent a paradigm shift—in many ways it is the American twin of the EU's sustainable finance strategy—it is not clear whether such legislation could pass Congress.

18 https://www.managedfunds.org/letters/mfa-aima-comment-letter-on-department-of-labor-proposed-proxy-voting-rules/
19 https://info.groom.com/28/646/uploads/2020-27465.pdf
20 Ibid.

Even with the Democrats' newfound acting Senate majority, the legislation will still need to overcome the Republican filibuster, unless Democrats were to change Senate rules in order to be able to invoke cloture on a simple majority. Second, assuming legislation could be passed on a simple majority, the Democrat caucus could not afford to lose a single vote, and would need the votes of senators like Joe Manchin of West Virginia—the heartland of the American coal industry—and Bob Casey Jr. of Pennsylvania—a hub for the fracking industry.[21]

There are, however, still many actions the Biden administration could take to push responsible investment. President-elect Biden has already indicated that he will issue an executive order requiring all executive agencies to take whatever steps they can to combat climate change. With control of the Senate, the Biden administration will be able to confirm agency heads more easily, which will have ripple effects throughout the regulatory sphere. The DoL's rule on proxy voting, will almost certainly be a target for repeal. The rule on financial factors, meanwhile, could also be replaced. The most likely replacement would be a rule that specifically allows, or perhaps even encourages, fiduciaries to consider material ESG factors. The SEC may well issue guidance to the wider financial services to that effect as well. Evidently there will be much for AIMA to track and engage with on behalf of members.

To complicate matters, however, individual states may take issues into their own hands. The state of Illinois, for instance, has instituted a Sustainable Investment Act for its public pension plans.[22] While the Act does not match the ambitions of the EU regulations, and of course does not directly touch private capital, it is still far closer to those regulations than it is to the current federal ones. Should the Act prove a success—and given the historically tenuous funding of Illinois public pensions, that remains an open question—other states may follow suit. California, a state that is home to a strong environmentalist movement, as well as a Democrat governor and veto-proof Democrat majorities in both houses of its legislature, would be an obvious candidate. California is also, of course, the fifth largest economy in the world. The end result may thus be a scenario in which the federal government creates a series of relatively restrained responsible investment regulations for private capital, focused on risk and return, while individual states take more aggressive actions with their public funds.[23]

In short, even with the new administration, we are unlikely to see significant regulatory convergence between the United States and the EU when it comes to responsible investment. Political realities, governmental structure, and indeed political culture all suggest that the United States federal government is not likely to embrace the dirigisme at the heart of sustainable finance. Rather, investment managers might see two different approaches to responsible investment. The EU will continue to focus on reshaping the economy; the United States, at least at the federal level, will likely continue focusing on the risks ESG factors pose to investments.

---

21 This is, of course, assuming the legislation would pass on party lines. While there has been some discussion of a bipartisan climate change bill, the discussion of climate change is generally far more polarised in the United States than in, say, the EU.

22 https://www.mayerbrown.com/en/perspectives-events/publications/2020/01/the-illinois-sustainable-investing-act---a-model-for-public-esg-investing

23 This dynamic can already be seen north of the American border, where a federal government that was elected on the promise of fighting climate change has thus far taken a relatively restrained approach to environmental regulation, while sub-federal jurisdictions—in this case, Quebec—take a more aggressive approach.