Defined Contribution
Institutional Investment Association

Incorporating ESG in DC Plans

A Resource for Plan Sponsors

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EXECUTIVE SUMMARY

Increasingly, retirement plan sponsors are considering whether sustainable investments and investment options could enhance their defined contribution (DC) plan retirement offerings. Heightened public awareness, evolving regulatory guidance, strides in data reporting, and investment product innovation have led plan sponsors to ask for more tactical guidance on applying strategies that integrate environmental, social and governance (ESG) criteria into plan design.

This paper provides tips for plan fiduciaries considering how to incorporate sustainable investing into a plan. Key recommendations include:

- Define “sustainability” and clarify investment beliefs around ESG considerations in relevant plan documents, such as a statement of investment beliefs or an investment policy statement (IPS).
- Examine key considerations and differences among three implementation options for DC plans to understand which path is most appropriate for the plan: material ESG factor integration across all investments, selective sustainable investing funds in the plan lineup, or self-directed brokerage windows.
- Measure and monitor sustainable investments in a manner consistent with the assessment of other investment options. Sustainable investing funds in alignment with pecuniary benefits, and other funds with goals or objectives independent of, but in alignment with pecuniary benefits, can be more deeply reviewed for intentionality[1] and for the ESG attributes of the underlying holdings.
- Consult with legal counsel and investment consultant(s) when assessing whether, when and how to implement sustainable investing.
- Maintain clear documentation throughout the process to establish procedural prudence.

In this paper, DCIIA aims to provide plan sponsors with tactical steps that are consistent with their fiduciary obligations.

TABLE OF CONTENTS

Responding to plan sponsor interest in sustainable investing, the Department of Labor (DOL) revisited the topic in 2020, making clear that any investment option within a DC plan must not sacrifice financial performance or add additional investment risk to the detriment of the duty of care. The Rule on Financial Factors in Selecting Plan Investments (the Final Rule), effective January 12, 2021, uses the terms "pecuniary" and "non-pecuniary" in framing sustainable investment decisions.[2] The Final Rule defines a pecuniary factor as one which "...a fiduciary prudently determines 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 and the funding policy."[3] The Final Rule acknowledges that ESG considerations can be pecuniary in nature and relevant to investment analysis, even as the ruling states ERISA fiduciaries must evaluate investments based solely on pecuniary factors.

In March 2021, the DOL announced that it will not enforce the Final Rule or otherwise pursue enforcement actions against a plan fiduciary that does not comply with the Final Rule for DC plan investments or an investment course of action, including for a qualified default investment alternative or QDIA.

While legislators and the DOL will continue to evolve their views and sustainable investing regulations, plan sponsors currently (at time of publication) have guidance to support integrating sustainable investing strategies into DC plan design—namely, to rely on a well-documented, prudent process that emphasizes materiality, diversification, risk and return in evaluating the duty of care, while relying on "prudent experts" as needed.

I. INTRODUCTION

Different segments of the US investment market have been increasingly adopting sustainable investment strategies. According to the 2020 Sustainable Investing Trends report from US SIF: The Forum for Sustainable and Responsible Investment, $17.1 trillion in assets are now invested in sustainable strategies in the US, an increase of 42% from 2018. (US SIF Foundation, "**Report on US Sustainable, Responsible and Impact Investing Trends," November 2020**.) This steady trend in growth reported by SIF suggests growing demand for sustainable investment strategies. Money flowing into sustainable investing strategies comes from a combination of institutional and retail investors, the former of which may be bound by ERISA standards. Plan sponsors are not precluded from integrating material ESG considerations into a plan's investment offerings; rather, plan sponsors can choose to document their selection process to demonstrate their investment philosophy and due diligence for such investments.

In this paper, DCIIA's second on sustainable investing in DC plans (the first being our 2019 paper, "**Sustainable Investing in DC Plans: A Guide for Plan Sponsors**"), we start with a refresher on "sustainable investments." We discuss how to raise the topic of sustainable investing within a committee and detail how governance documents might be amended to reflect its role in the plan's investment philosophy. Next we briefly examine some legal and fiduciary considerations in light of shifting regulatory views on sustainable investing. We then describe a plan sponsor's implementation options. Following implementation, we provide communications tips to improve participant engagement and education on ESG integration. We conclude with detailed steps on monitoring and evaluation.

Throughout this paper, DCIIA recommends seeking prudent expert advice, documenting processes, and conducting ongoing measurement to fulfill responsibilities consistent with fiduciary duties. We hope plan sponsors and their fiduciary partners find this resource useful when aligning plan design with modern investment practices and prevailing relevant rules and regulations.

II. DEFINING SUSTAINABLE INVESTMENTS

What makes an investment "sustainable"? Portfolios are considered sustainable when decision makers weigh the impact of ESG factors alongside other traditional financial metrics in portfolio construction and investment management processes. **(Exhibit 1)**

Exhibit 1
Examples of ESG Factors

WHAT ARE ENVIRONMENTAL, SOCIAL AND GOVERNANCE (ESG) FACTORS?

ENVIRONMENTAL

- climate change
- greenhouse gas emissions
- resource depletion, including water
- waste and pollution
- deforestation

SOCIAL

- working conditions, including slavery and child labor
- local communities, including indigenous communities
- conflict and humanitarian crises
- health and safety
- employee relations and diversity

GOVERNANCE

- executive pay
- bribery and corruption
- board diversity and structure
- fair tax strategy

Sources: European Parliament Think Tank, "Sustainable finance and disclosures: Bringing clarity to investors," 2019; Principles for Responsible Investment.

While organizations like the Principles for Responsible Investment (PRI), the Task Force on Climate-related Financial Disclosures (TCFD), and the Value Reporting Foundation have helped to standardize the scope of sustainability criteria, in practice the definition of "sustainable investment" varies by organization, asset class and strategy. Since numerous criteria can qualify as sustainability measures, each plan sponsor can define their parameters -- just as they would for "growth," "value," or "defensive" strategies. Given the increased attention on sustainability topics, plan sponsors may want to align with interested/involved parties on definitions, priorities, legal constraints and goals.

DCIIA's Sustainable Investing Terminology

We define "sustainable investing" as an investment philosophy that seeks to generate financial value by incorporating environmental, social and governance values. This umbrella term includes multiple approaches, such as integrating ESG factors into a fund, as well as funds that incorporate macro ESG-themes.

- **ESG integration** – systematically including relevant and material ESG factors into securities analysis alongside other traditional financial metrics (e.g., P/ E ratio). ESG factors focus on financial materiality for a sector or industry (e.g., data security is more relevant to banking than to agriculture) and contribute to an investment's risk/return outlook.

- **ESG-themed funds** – a top-down investment approach enables investors to gain positive exposure to macro themes (e.g., diversity, climate change, etc.) through their investments. For pooled vehicles, the stated investment objective or investment strategy explicitly describes an environmental, social or governance theme. ESG-themed funds aim for an optimal risk/return outcome for investments in sectors relevant to the targeted theme. Pecuniary factors of standalone ESG-themed funds can be demonstrated with proper ongoing monitoring and documentation.

Source: DCIIA, "Sustainable Investing in DC Plans: A Guide for Plan Sponsors," May 2019

III. INTEGRATING SUSTAINABILITY INTO GOVERNANCE DOCUMENTS

DC plan sponsors often oversee complex governance structures with demanding documentation requirements. A series of checks and balances and a demonstrable decision-making process along with thorough documentation help demonstrate that plan sponsors are meeting their fiduciary responsibilities. Clear documentation outlining consistency in due diligence and execution of duty of care can, in turn, help to demonstrate consistency in process, philosophy and execution, and help address concerns about meeting fiduciary duties. Further guidance on common documentation practices can be provided by ERISA counsel and investment consultants.

Sustainable investing, whether selecting a standalone fund or incorporated into a plan's overall investment decision making, is relatively new in the US. Yet DC plan sponsors can identify common practices for consideration as a foundation for proactively building a governance framework.

Checklist: Discussing ESG with a Board or Committee

Various catalysts increasingly spark a conversation about sustainable investing, such as an inquiry from a board member, plan participant interest, a change in company leadership or priorities or changes in legal regulatory guidance. This checklist helps guide an informed discussion among board / investment committee members as they consider applying a sustainable investment lens to the plan's design:

- √ Read the latest sustainability-related news and research. Consultants and specialists can provide targeted education.
- √ Assess how sustainability fits within the organization's broader business model—including mission, organizational structure, and financial reporting—when assessing how to define sustainability and incorporate ESG factors into the investment plan.[4]
- √ Discuss how utilizing a sustainable investment lens can fulfill the board's fiduciary duties.
- √ Confirm that the board / investment committee sees sustainability as pecuniary and consistent with the plan's long-term investment goals.
- √ Consider how embedding ESG factors into the investment framework might impact participant engagement and outcomes, as well as investment selection and monitoring.[5]

One often used practice is to define and detail sustainable investing in two governance documents: the investment policy statement (IPS) and a statement of investment beliefs. Investment beliefs can be part of an IPS or a separate document. Three quarters of DC plan sponsors overseeing plan assets of greater than $1 billion report following an Investment Policy Statement.[6] While investment belief statements are less commonly used by large plan sponsors (approximately 1 in 4), these documents can also facilitate integration of sustainability criteria.

Plan sponsors can modify the IPS and statement of investment beliefs to prudently expand their sustainable investment practices and articulate their philosophy.

Sample Sustainability Statements

Investment Policy Statement (IPS):
Plan sponsors can incorporate a statement into the IPS incorporating sustainability considerations into the investment decision-making process. One example: "Our plan considers financially material ESG factors within its investment processes for all fund options, including the QDIA."

Statement of Investment Beliefs:
This statement can also be appropriate for introducing sustainable investment criteria. Currently, few corporate DC plans have investment belief statements that integrate sustainable investment language; this is more common among public plans. Statements of investment beliefs can be stand-alone documents or included as an appendix to an IPS. For example, CalSavers, the California state-run IRA program, lists sustainable investment as one of its 10 Investment Beliefs within its IPS: "Responsible social, environmental, and governance investing is an issue important to some Participants, and an Investment Option reflecting that belief should be offered."

Source CalSavers Retirement Savings Program, "Investment Policy Statement," California Secure Choice Retirement Savings Investment Board, 2019.

Incorporating language supporting sustainability and ESG factors into documents such as the IPS and/or the statement of investment beliefs can support prudent exercise of fiduciary responsibilities. Investment beliefs commonly follow "modern portfolio theory" concepts, which assume plan fiduciaries are rational investors and make decisions based on complete information. These concepts are consistent with material ESG integration such as when sustainable investing indicators positively impact an investment's risk/return profile and when material ESG considerations are implemented to seek to improve the risk-adjusted return for the participant.[7]

Some of the research supporting materiality of ESG factors is detailed in our earlier paper, "**Sustainable Investing in DC Plans: A Guide for Plan Sponsors**", (available in our online Resource Library) and the enhancements to monitoring and reporting on ESG factors are further considered in Section 7 of this paper. As discussed in the next section, plan sponsors can also seek guidance regarding fiduciary responsibilities from their legal counsel and investment consultants.

Checklist: Pre-implementation Considerations

- √ Has your investment committee / board discussed whether to include specific sustainability language in your IPS with your investment consultant and legal counsel?
- √ Have you discussed what type of ESG criteria should be considered in the potential selection and monitoring of funds with your investment consultant? Are the criteria financially material and in the best interest of the plan participants?
- √ Have you reviewed the investment criteria in the IPS periodically during investment committee / board meetings? Be careful about language that may be forgotten or is difficult to follow.
- √ Is your investment committee archiving a well-reasoned and well-documented process in its meetings' minutes?
- √ Do your investment criteria fall within applicable guidance under ERISA (or other applicable law)?
- √ Has your participant communication plan been discussed and documented?

IV. LEGAL AND FIDUCIARY CONSIDERATIONS

Given sustainable investing is trending relatively recently in the US DC plan marketplace, DC plan-specific regulatory guidance and/or case law has been fairly limited. That said, similar to the approach adopted in recent rulemaking, plan fiduciaries navigating ERISA and DOL requirements when integrating measurable sustainability goals can look to the "sole interest" and "exclusive purpose" rule (also referred to as the fiduciary "duty of loyalty") for guideposts. For example, this could be explained as:

1. the plan fiduciary reasonably concludes the investment program will benefit DC plan participants and beneficiaries directly by improving risk-adjusted return, and;
2. the plan fiduciary's motive for adopting the investment program is to obtain this direct benefit.

As another example, DC plan sponsors using a sustainable investing framework may wish to emphasize diversification, risk and return and/or identify expert advisors (that may be ERISA 3(21) or 3(38) investment fiduciaries) to establish a comprehensive due diligence process by analyzing the sustainable investing approach, including potential investment options, comparative performance data, and peer benchmarking on an ongoing basis. Maintaining records of this type of information helps plan fiduciaries fulfill their fiduciary obligations regarding investment selection and monitoring, as well as maintaining "procedural prudence."

Previewing Section 7: Monitoring Sustainable Investments

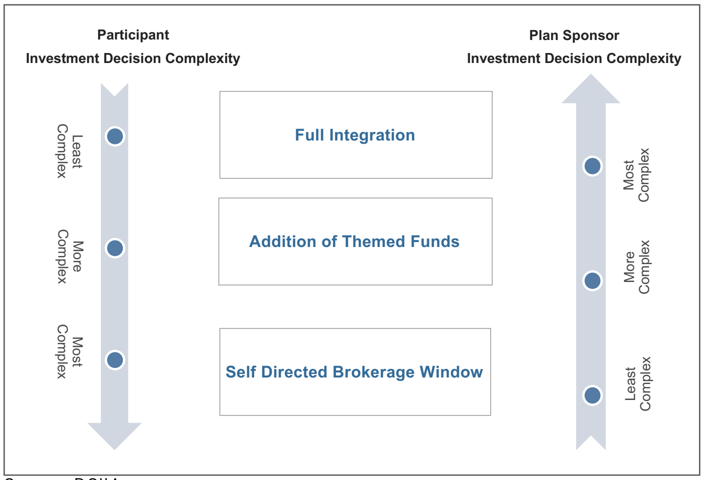
When assessing potential investment options' sustainable attributes, some plan sponsors and their investment consultants are leveraging inputs, such as fund-level sustainability metrics, as part part of their manager research process. ESG-scoring methodologies can include a matrix of material factors believed to impact the manager's ability to generate excess risk-adjusted returns on an absolute basis and relative to peers. Combining insights from regular due diligence meetings with proprietary and third-party data regarding sustainable criteria can aid plan sponsors in developing a defendable, repeatable process to assess sustainable strategies. This process could include ongoing monitoring, including cost sensitivity analysis of investment selection, proxy voting, or other engagement with management.

Investment consultants can play an important role, as a growing number are assessing asset managers and investment strategies based in part on ESG attributes. Plan sponsors can also ask investment consultants about their capabilities for assessing investment managers' ESG approaches. A plan sponsor relying on a "prudent expert" can question and seek to understand the research process and how the consultant integrates ESG-specific criteria.

V. METHODS FOR IMPLEMENTING SUSTAINABLE INVESTMENTS

DC plan implementation for sustainable investing can be accomplished in multiple ways **(Exhibit 2)**. In this section, we review the options in order of complexity (i.e., in order of responsibility for the participant or plan sponsor), as well as impact for plan participants, delineating the level of complexity also involved for plan sponsors.

Exhibit 2
ESG Implementation Model



Source: DCIIA

A. Full-Plan ESG Integration

Full-plan ESG integration is a comprehensive approach that utilizes sustainable investing attributes in manager selection and ongoing evaluation for all the plan's investment options, including the qualified default investment alternative (QDIA). The plan sponsor considers sustainable investing attributes that are financially material to the investment strategy as part of the evaluation and selection of each investment option.

Materiality: A Commonly Accepted Investing Principle

In 2018, the CFA Institute and PRI jointly defined ESG integration as "… the explicit and systematic inclusion of ESG factors in investment analysis and investment decisions." Financially material sustainability issues are those attributes that are likely to affect the financial condition or operating performance of companies within an industry. The Value Reporting Foundation has developed the SASB Materiality Map®, which identifies 26 sustainability-related business issues and their relevance by industry.

Sources: Matt Orsagh et al., "ESG Integration in The Americas: Markets, Practices, and Data," CFA Institute, 2018; PRI, "Guidance and case studies for ESG integration: equities and fixed income," 2018; and, SASB Materiality Map.

Integration requires the least participant effort to select and build a sustainable portfolio since sustainable investment attributes are included in all available investment options. This approach may introduce additional decision-making considerations regarding manager selection and ongoing assessment for the plan sponsor but may be the most straightforward from a participant's perspective, as the onus of due diligence and strategy stays on the plan sponsor. An investment consultant can provide support on these additional considerations.

In adopting a full-integration method, plan fiduciaries could choose to outline ESG criteria for each asset class, build request-for-proposal (RFP) questions that delve into those criteria, and design portfolio reviews to include material sustainability factors directly impacting the investment strategy's financial outcomes. Examples of topics plan sponsors could discuss with asset managers include the integration process, material considerations, data sources used, and portfolio reporting and benchmarking.

Plan sponsors may start by assessing a manager's commitment to long-term sustainability. This due diligence may consider whether the manager has a clear philosophy around integrating sustainability criteria into the investment process; if the manager has dedicated staff resources to focus on sustainability; and if the manager has direct involvement in relevant industry initiatives. Stewardship, such as proxy voting and engagement activities, is another tool that integration strategies may use in portfolio management aligned with sustainability criteria.

Qualified Default Investment Alternatives (QDIAs)
Another way plan sponsors could seek to pursue an integrated sustainable investing approach is through QDIAs, such as target date funds (TDFs), balanced funds or managed accounts. For example, plan sponsors could choose between off-the-shelf QDIAs or custom QDIAs, which incorporate ESG criteria.

Plan sponsors seeking off-the-shelf options that incorporate ESG criteria may find more limited options and historical performance data than are available with custom QDIA solutions. Building a custom solution allows the plan sponsor to choose the underlying asset classes and managers, but this approach also requires more time and resources than an off-the-shelf option. Certain asset classes may not have an ideal or accessible sustainable investment option, due to lack of product or a short track record. Each plan sponsor can consider the plan's unique situation when deciding between buying and building a QDIA. For a more detailed discussion about the resources required to build a QDIA, see DCIIA's paper, "**Considerations for Implementing a Custom Target Date Approach: A Guide for Defined Contribution Plan Sponsors**," 2011.

The DOL's Final Rule on Financial Factors in Selecting Plan Investments included a special rule for QDIAs which adopted a "heightened prophylactic approach for QDIAs" and expressly provided that in no circumstances may any investment fund, product, or model portfolio be "added as, or as a component of, a qualified default investment alternative described in 29 CFR 2550.404c-5 if its investment objectives or goals or its principal investment strategies include, consider, or indicate the use of one or more non-pecuniary factors." These new special rules for QDIAs included a deferred compliance date of April 30, 2022 and so are not currently (as of date of this paper's publication) in effect. Also, as previously noted, in March 2021, the DOL announced that it will not enforce the Final Rule or otherwise pursue enforcement actions against a plan fiduciary that does not comply with the Final Rule. We suggest that plan sponsors check in with their ERISA counsel for up to date guidance on whether any special rules apply to QDIAs.

B. Addition of ESG-Themed Funds

Plan sponsors can choose to add sustainable investing funds as core menu options or make them available through the self-directed brokerage window.

Core Menu
Plan sponsors might prefer to shift some decision-making around adopting sustainable investments to participants, in which case stand-alone fund options may be a more appropriate course of action. Plan sponsors can add sustainable investing- funds across multiple asset classes, or more selectively in certain asset classes. Questions to consider when looking at stand-alone options include:

- How many sustainable investing funds are appropriate (i.e., does a single investment option make the most sense or does the plan sponsor wish to provide enough building blocks for a participant to build a full sustainable investing portfolio)?
- How does the fund align with participant demand (i.e., most assets are in equities, so adding a sustainable equity option makes the most sense)?
- How would participants' asset allocations be expected to change with the addition of the fund?

Sustainable investing funds often incorporate an approach that enables investors to gain positive exposure to macro themes (e.g., diversity, climate change, etc.) through their investments. The fund name may attempt to convey the fund's theme. According to 2019 data from the Callan DC Index, the most common asset classes for sustainable-themed funds are domestic, global and developed ex-US equity, and balanced funds. US equity—large-cap in particular—is an asset class with early sustainable investing adoption and product development, making it a leading contender for plan sponsors considering choices in themed options. Balanced funds are also prevalent. These funds appeal to plan sponsors seeking a sustainable investing option with exposure to equity and fixed income.

Sustainable investing funds utilize varying approaches to integrating sustainable investing criteria. **Exhibit 3** illustrates the various approaches, based on prospectus language. For that reason, plan sponsors will often seek to understand the investment thesis, security selection process, and any frameworks being used to assess the materiality of the sustainable investing criteria. For pooled vehicles, the stated investment objective or investment strategy generally explicitly describes an E, S and/or G theme. These funds aim for optimal risk/return outcomes for investments in relevant sectors to the targeted theme, and can be found in active, quantitative and passive investment strategies.

Exhibit 3
Sustainable Funds

	Sustainable Fund Types		
ESG Consideration	**ESG Focus**	**Impact/Thematic**	**Sustainable Sector**
Strategy "considers" ESG factors but sustainability not central	Strategy has intentional ESG Focus: - Incorporates ESG in security selection and portfolio construction - May use exclusions - Engages in active ownership	Strategy has intentional Impact/ Thematic focus: - Seeks impact alongside financial returns - May incorporate ESG in security selection and portfolio construction - May use exclusions - Engages in active ownership	Strategy focused on "green economy": - Renewable energy - Energy efficiency - Environmental services - Climate resilience - Water - Green real estate - Green transportation - Food
Diversified Strategies			

Source: Source: Jon Hale, "Sustainable Funds U.S. Landscape Report," Morningstar, 2019.

*Impact funds are defined as investments made with the primary goal of fostering a specific positive social or environmental change, and that also seek to earn the investor a positive return. (Source: DCIIA, "Sustainable Investing in DC Plans: A Guide for Plan Sponsors," 2019.)

Dedicated sustainable investment options present a path for plan participants who want to opt into sustainable investing, but they can also be utilized as building blocks to create a custom TDF incorporating ESG.

Plan Design Considerations for Adding Sustainable Investing Funds

Plan sponsors can consider how to frame the position of a dedicated sustainable investing fund, or funds, in plan design and consider the following:

- **Fund Architecture:** Consider how to allocate to specific fund(s) and understand their differences from other funds in the asset class or menu.
- **Participant Communications:** Inform plan participants how the fund(s) address sustainability considerations. Plan sponsors can communicate this alongside information on standard features about the fund.
- **Product Availability:** There are currently more sustainable investment funds available for public equities than for other asset classes. Plan requirements (such as track record, particular vehicle type, or investment style) may limit the pool of potential sustainable investing choices.

Integrating sustainability considerations across the investment lineup and adding stand-alone sustainable investing funds to the plan lineup are approaches for providing plan participants access to sustainable investments that can be vetted and approved through the plan due diligence process. If instead these options prove to be incompatible with the plan, plan sponsors can offer participants access to sustainable investments via a brokerage window.

C. Self-Directed Brokerage Window

A self-directed brokerage account (SDBA) or brokerage window is another way plan participants can access sustainable investments. This option requires the most responsibility for decision making on the part of the participant. When using the SDBA, participants are responsible for moving assets to the SDBA, selecting sustainable investing investment options from the broad array of investment choices in the SDBA, and monitoring those options on an ongoing basis.

Brokerage windows enable plan participants to access and select from a potentially broader suite of sustainable investment options while plan sponsors avoid adding more options to the core fund lineup. However, given that the sponsor is not required to run the same due diligence and approval on options through the brokerage window, more of an onus is on the plan participant to research and identify appropriate investment options. A brokerage window might be ideal for an informed population of committed and involved investors to pursue sustainable investing, but less appropriate for other plans.

Implementation Summary

Sustainable investments require differing levels of resources and time frames to implement. The implementation approach should be carefully reviewed when considering how to include sustainable investing. Plan sponsors pursuing effective integration will commit the most time and resources if they choose to integrate sustainability across investments. Alternately, providing a brokerage window puts the responsibility on plan participants, thus requiring significantly less time and resources from plan sponsors unable to pursue integration or stand-alone sustainable investing funds.

VI. PARTICIPANT COMMUNICATIONS

Given the need to maintain a balanced approach when educating participants about plan investments, plan sponsors may consider the following communication strategies in the context of sustainable investments:

Leverage Existing Participant Communications Best Practices: Sustainable investment option discussions with participants are no different than discussing other investment types. Plan sponsors can use the same strategies[8] to inform participants about sustainable investments, such as:

- Take a campaign approach
- Build an emotional connection and make the communication personal
- Keep the message simple
- Use behavioral finance techniques
- Consider using gamification and interactive tools
- Leverage external marketing resources to educate and build awareness.

Conduct an Employee Survey: Surveying employees about their retirement plan shows that employers care about employees' opinions and want their input to design the best plan. A broader employee survey could pose questions to gauge participants' interest in sustainable investment options.

Plan sponsors proactively addressing ESG considerations in plan design can potentially improve engagement with employees for whom sustainability is important. Recent research shows that 72% of the U.S. population expressed at least a moderate interest in sustainable investing, without significant variation across gender or generations, when controlling for sociodemographic variables.[9] In addition, 67% of millennials say they would contribute more to their plan – or invest for the first time – if it advanced the social good.[10]

Leverage Fund Change Notifications: Depending upon the implementation approach used, an automatic advance notice requirement to plan participants may be triggered (for example if there are changes to the plan's investment lineup). We suggest that plan sponsors review applicable advance notice requirements with their ERISA advisors.

Consider the advance notice requirement as an opportunity to highlight the funds' sustainability attributes, alongside required investment information. This required notification offers an opportunity to restate the plan's investment beliefs.

Enlist Service Providers: Support from the plan's providers--including financial professionals, asset managers, consultants, counsel and/or recordkeepers--can send a consistent message around sustainable investing. Financial professionals who regularly communicate with employees through group enrollment and education meetings, or one-on-one sessions, can provide objective research and information on sustainable funds. Consultants and recordkeepers can provide research, leverage experience with other DC plans, and offer input on how best to communicate about the funds.

Integrate Sustainability Rankings Alongside Performance Data: Some sustainable investing funds do not emphasize their investment processes' ESG criteria in communications, such as fund fact sheets. Consequently, plan participants might not be aware that their assets are being managed according to sustainability criteria. Plan sponsors can ask their service providers – recordkeepers, consultants, and asset managers – to provide current fund performance reporting with ESG information, such as sustainability rankings and methods, to provide a level of transparency for participants.

VII. SUSTAINABLE INVESTMENTS MONITORING

Sustainable investment funds' financial metrics (e.g., risk, return, fees, etc.) can be monitored in the same rigorous manner as other investment options; in addition, they can expand monitoring by adding ESG metrics in reporting and including ESG due diligence questions in RFPs. As most performance reports pass through several service providers (e.g., custodian, recordkeeper, and investment consultant); plan sponsors may want to request their service providers include sustainability information in monthly, quarterly and annual reports. As with incorporating sustainable investing philosophy into governance documents, noted previously, requests for proposals (RFPs) can be updated to reflect material ESG integration or other specifics relative to sustainable investing funds, which are explored further in this section.

A. Documenting the Evaluation of ESG Integration Across the Plan

When incorporating sustainability considerations into the retirement plan process, the plan sponsor should document its due diligence and decision making (procedural prudence). One aspect of evaluating ESG integration can consider service providers' sustainability practices at the organizational level, in addition to investment options.

Review Service Provider Policies
Due diligence processes for services related to the plan may include assessments of the provider's organizational stability, people and practices. This due diligence can be extended to address sustainability. As a starting point, plan sponsors can request a service provider's documentation, including the following: a corporate social responsibility policy, sustainability reports, and diversity and inclusion initiatives. In addition, fiduciaries can request more quantitative elements, such as year of implementation and last update of the policy, goals and achievements, and relevant statistics for benchmarking. This firm-level due diligence can be augmented by deeper examination of operational and product-level ESG integration, as well as a manager's active engagement methods.

Assess Core Menu Options by Looking at ESG Ratings of the Underlying Holdings
Increased investor demand for ESG information is driving publicly traded companies to boost transparency around their sustainability policies and practices.[11] This information is collected and aligned with frameworks by a quickly expanding field of ESG research and data providers. Multiple providers have emerged in recent years, ranging from comprehensive to specialists, AI-driven, NGO, etc. Plan sponsors – and their investment consultants and other service providers – now have more ways to evaluate a company's long-term material ESG risk-mitigation abilities. ESG assessments facilitate understanding of how well companies are positioned to balance financial, natural and human capital in decision-making.

There are many security-level ESG research and ratings providers, including Sustainalytics (recently acquired by Morningstar), MSCI, RobecoSAM (now part of S&P Global), Vigeo Eiris (an affiliate of Moody's Investor Services), ISS (owned by Deutsche Börse), Refinitiv and others. Some of these ratings are used to assess the aggregate portfolios as well, such as:

- Morningstar Sustainability Rating: Aims to measure how well the issuing companies of the securities within a fund's portfolio holdings are managing their ESG risks and opportunities relative to the fund's Morningstar Global Category peers (with the measurement scale being one to five globes)

- MSCI ESG Fund Ratings: Designed to measure the ESG characteristics of a fund's underlying holdings, making it possible to rank or screen mutual funds and ETFs on a AAA to CCC ratings scale (relative to Lipper global benchmark group)
- ISS ESG Fund Ratings: Rates funds based on holdings' ESG performance score relative to Lipper global benchmark group (on a 1-5 stars rating scale)

The above tools represent a subset of the providers and resources that can be used to monitor the fund's ESG quality, and can be included in the reporting by some custodians, recordkeepers and investment consultants. While there is general agreement on topics considered material for various industries, thanks to TCFD and Value Reporting Foundation, each data provider has a unique approach to ESG-research frameworks and ratings. In addition to the available third-party data, many investment managers have developed their own ESG scoring processes. These scoring systems provide a way to incorporate a manager's qualitative information to rate corporations on material ESG metrics. Understanding the differing approaches to ratings and scoring methodologies, how investment managers use them or have paired them with internally created scoring systems and potentially creating a custom approach to rating, can be part of a prudent process in integrating ESG.

B. Evaluation of ESG-Themed Funds

In addition to the financial evaluation, other considerations for sustainable investing funds involve monitoring their adherence to their stated commitments around ESG goals or objectives, and demonstrably active ownership, as outlined by PRI.[12] Due diligence of sustainable investing funds can be achieved through top-down and bottom-up analysis, both of which will shed light on the ESG qualities of the fund's underlying holdings. Additionally, many consulting firms have integrated a qualitative interview assessment when meeting with managers.

Identify & Assess Intentionality

The stated sustainable outcome or approach, often contained in the investment objective or expressed as a goal on a fact sheet or in a prospectus, is integral in assessing an ESG-themed fund. Fiduciaries can assess the alignment between words and actions using third-party research and databases. While expressing ESG intentionality in fund names and prospectus documents communicates a manager's commitment to ESG, the stated commitment can be checked against the fund's holdings, as described earlier. If a fund is found to perform very poorly in its sustainability rating, fiduciaries can request additional documentation during the manager review process.

Understand Active Ownership

Active ownership is the exercising of shareholder rights through voting or engagement. There are many gradients of active ownership across all asset classes and strategies, whether or not they are sustainability focused. In most cases, DC plan fiduciaries delegate this responsibility to their 3(38) investment service providers to track proxy voting and shareholder engagement on the part of the investment managers offered in the plan. Within the context of sustainable investing funds, assessing sustainability-related active ownership might include reviewing fund managers' stewardship policies and reports, proxy voting track records, and support for ESG-related shareholder resolutions. Multiple providers track these records and can report on them, including Broadridge Financial Solutions, Glass Lewis, Institutional Shareholder Services (ISS), Proxy Insight and Morningstar.

C. Performance Benchmarking

Much like the product landscape for sustainable investments, the availability of ESG indexes has accelerated in recent years. Nearly all mainstream index providers now offer ESG-focused families that are useful for passive ESG investing; however, they are rarely used as primary performance benchmarks. Investors may use traditional indexes to assess performance for ESG-themed and ESG-integrated funds; however, it can be useful to select an ESG index as a secondary benchmark. With an ESG-themed fund, the investment manager may have a recommended ESG index to benchmark against.

VIII. CONCLUSION

With proper process and documentation, plan sponsors may consider assessing and integrating sustainable investing into retirement plans. The regulatory approach toward sustainable investing may shift in the future; however, if plan sponsors continue to demonstrably put plan participants' economic benefits first, plans can be compliant even with current more stringent regulations. There are a variety of ways to begin, including assessing the current platform's sustainability attributes, integrating sustainability questions into standard manager RFPs or due diligence, and formulating a committee philosophy on sustainable investing.

With thoughtful consideration and clear, consistent documentation, plan sponsors may articulate how access to sustainable investing strategies fit in plan design and use this process as a means for participant education and engagement. DCIIA believes that through research, deliberation, documentation, and attention to the duties of loyalty and prudence it is possible to successfully incorporate sustainable investing in today's DC plans. DCIIA looks forward to continuing to serve as a trusted resource on this important topic as the dialogue continues.

Endnotes

[1] An investor's intention to have a positive social or environmental impact through investments.

[2] While the term *pecuniary* may be new to the ESG discussion in DC plan dialogue, its antonym, *non-pecuniary*, was first introduced into ERISA with the final June 2014 United State Supreme Court ruling in the employee stock drop case, *Fifth Third Bancorp v. Dudenhoeffer.* In that case, the Supreme Court found a breach of fiduciary duty, as it rejected the notion that "ERISA's duty of prudence varies depending upon the specific nonpecuniary goal set out in an ERISA plan." Within this context, the non-pecuniary benefit was employee ownership of employer stock. The ruling reaffirmed the exclusive purpose rule of providing benefits to participants and their beneficiaries while defraying reasonable expenses of administering the plan. (Source: Supreme Court of the United States. Fifth Third Bancorp et al v. Dudenhoeffer et al. Decided June 25, 2014. https://www.supremecourt.gov/opinions/13pdf/12-751_d18e.pdf)

[3] U.S. Department of Labor, Employee Benefits Security Administration "Final Rule on Financial Factors in Selecting Plan Investments, October 30, 2020. https://www.dol.gov/agencies/ebsa/about-ebsa/our-activities/resource-center/fact-sheets/final-rule-on-financial-factors-in-selecting-plan-investments

[4] While the Biden Administration has announced that it will not enforce the DOL's Final Rule on Financial Factors in Selecting Plan Investments, we note the preamble discussion published with the Final Rule advised: Public companies and their investors may legitimately pursue a broad range of objectives, subject to the disclosure requirements and other requirements of the securities laws. Pension plans and other benefit plans covered by ERISA, however, are bound by statute to a narrower objective: Prudent management with an "eye single" to maximizing the funds available to pay benefits under the plan. Providing a secure retirement for American workers is the paramount, and eminently worthy, "social" goal of ERISA plans; plan assets may never be enlisted in pursuit of other social or environmental objectives at the expense of ERISA's fundamental purpose of providing secure and valuable retirement benefits.

[5] The DOL's Final Rule on Financial Factors in Selecting Plan Investments included the following preamble discussion: … the Department has repeatedly explained that increased plan contributions and similar factors are not economic factors, but … are the type of non-economic factor that may be considered where a fiduciary is permitted to make an investment decision on the basis of a non-pecuniary factor. Increasing plan contributions and similar factors do not assist a fiduciary in determining the expected return on or riskiness of an investment, as plan contributions do not constitute a "return" on investment.

[6] DCIIA Retirement Research Center (RRC) / U. Mass. Boston 2019/2020 ESG study. Based on an online survey fielded during Q4 2019. Data reflects sample of 140 plan sponsor respondents.

[7] Schanzenbach, M. M., & Sitkoff, R. H. "Reconciling Fiduciary Duty and Social Conscience: The Law and Economics of ESG Investing by a Trustee." Discussion Paper No. 971. *Stanford Law Review*, April 2019.

[8] Segal Benz, "Unlocking Successful Benefits Communication," January 2018

[9] Morningstar, "The True Faces of Sustainable Investing: Busting the Myths Around ESG Investors," 2019

[10] Natixis Investment Managers, "2019 Defined Contribution Plan Participant Survey," April 2019

[11] For example, on December 7, 2020, the Investment Company Institute (ICI) Board of Governors, representing mutual fund investors, approved a statement encouraging US public companies to provide enhanced reporting on ESG issues. https://www.ici.org/pressroom/news/20_news_esg

[12] See, "Introductory Guides," PRI website, https://www.unpri.org/investment-tools

ABOUT DCIIA

The Defined Contribution Institutional Investment Association (DCIIA) is a nonprofit association dedicated to enhancing the retirement security of America's workers. To do this, DCIIA fosters a dialogue among the leaders of the defined contribution community who are passionate about improving defined contribution outcomes. DCIIA's diverse group of members include investment managers, consultants and advisors, law firms, recordkeepers, insurance companies, plan sponsors and other thought leaders who are collectively committed to the best interests of plan participants. For more information, visit: www.dciia.org.

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