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Publications

DOL Shifts Focus From ESG to Pecuniary Factors in Final Rule

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On October 30, 2020, the Department of Labor ("DOL") issued its much-anticipated final rule on Financial Factors in Selecting Plan Investments (the "Final Rule"). The Final Rule amends the DOL's long-standing "investment duties" regulation, which previously focused only on how fiduciaries could satisfy their duty of prudence under the Employee Retirement Income Security Act of 1974, as amended ("ERISA"). The Final Rule amends that regulation by adding "minimum standards" to satisfy the duty of loyalty under ERISA, in addition to other changes.[1]

In a general sense, the Final Rule is arguably a codification of principles articulated in prior DOL guidance over the past several decades that emphasize "the primacy of plan participants' economic interests" in investment decision-making. Compared to the DOL's proposed rulemaking (issued on June 23, 2020) (the "Proposed Rule")[2], the Final Rule contains a more streamlined set of requirements and, as such, eliminates certain controversial aspects of the Proposed Rule. Notably, the Final Rule removes any reference to environmental, social and governance ("ESG") factors, and instead shifts its focus to the use of pecuniary and non-pecuniary factors.

At bottom, the Final Rule requires that fiduciaries evaluate investment opportunities based upon pecuniary factors. However, if fiduciaries are unable to distinguish investments based on pecuniary factors (a circumstance that the DOL continues to view as a "rare" event), the Final Rule permits fiduciaries to consider non-pecuniary factors as a tie-breaker provided that they comply with the Final Rule's documentation requirement. Like the Proposed Rule, the Final Rule includes restrictive conditions for investments used as a plan's qualified default investment alternative ("QDIA"). Specifically, the Final Rule prohibits fiduciaries from including investments whose investment strategies "consider, include, or indicate the use of non-pecuniary factors" as the plan's QDIA.

I. Overview of the Final Rule

The following describes the Final Rule's key features, including notable differences from the Proposed Rule:

A. Clearer Articulation of Fiduciary Duties

Since it became effective in 1979, the "investment duties" regulation applied only to the ERISA fiduciary duty of prudence. However, the Proposed Rule sought to integrate the ERISA duty of loyalty into the regulation by adding a five-part test. In response to comments expressing concern that the Proposed Rule blurred the two duties and "could violate established principles of statutory construction," the Final Rule preserves the duties' distinctions by describing the requirements for each duty in separate sections. In addition, the DOL responds to concerns as to whether the regulation would continue to operate as a "safe harbor" with respect to the application of the duty of prudence to investment decisions. In this regard, the DOL notes that while the provisions of the Final Rule relating to the duty of prudence continue to provide a safe harbor, the new provisions regarding the duty of loyalty "are set forth as minimum requirements."

The Final Rule also includes a substantially simplified statement of the duty of loyalty in response to comments that requested that the DOL "replace its multi-part articulation of the duty of loyalty in the proposal with a simple clarification." In this regard, the Final Rule states that fiduciary investment decisions "must be based only on pecuniary factors" and that fiduciaries "may not subordinate the interests of participants and beneficiaries in their retirement income or financial benefits under the plan to other objectives."

In addition, with respect to the ERISA duty of prudence, the Final Rule helpfully clarifies that for purposes of a fiduciary's determination that an investment or investment course of action is "reasonably designed" to further the purposes of the plan, the fiduciary is required only to have considered investment alternatives that are "reasonably available under the circumstances." This limitation on the consideration of investment alternatives to only those that are "reasonably available" responds to commenters' concerns that the Proposed Rule could be interpreted to require fiduciaries to "scour the market" and "incur search costs on a practically infinite number of potential portfolios."

B. Emphasis on Pecuniary Factors Instead of ESG Considerations

Perhaps the most significant change in the Final Rule is the removal of references to ESG and similar concepts from the regulatory text. In the preamble, the DOL notes that although such terms were "used in common parlance when discussing investments and investment strategies," they do not have uniform definitions and thus are not "clear or helpful lexicon for a regulatory standard." In removing references to ESG and similar concepts, the DOL acknowledges that given the complex interplay of ESG factors in investment decision-making, the term "ESG" is not necessarily synonymous with "non-pecuniary."

In an effort to clarify the DOL's position, the Final Rule requires that fiduciaries "focus on whether a factor is pecuniary, rather than being required to navigate imprecise and ambiguous ESG terminology." Specifically, the DOL notes that "[a]t the time of the investment decision, fiduciaries should be focused on whether or not any given factor would materially affect the risk and/or return of the investment over an appropriate time horizon."

Notably, the Final Rule also revises the definition of "pecuniary factor" to provide more flexibility to fiduciaries to determine what constitute such factors. Specifically, the revised definition defines "pecuniary factor" as "a factor that *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 established pursuant to section 402(b)(1) of ERISA" (emphasis added).

The DOL notes that the added flexibility in the definition would leave it to ERISA fiduciaries to evaluate and determine whether certain arrangements (e.g., use of proprietary products, fee sharing, fee aggregation) or certain factors (e.g., brand or reputation) would affect the risk/return calculus of an investment, and therefore constitute pecuniary factors.

C. Survival of the "All Things Being Equal" Test

Consistent with longstanding DOL guidance, the Final Rule expressly permits consideration of non-pecuniary factors when the fiduciary is unable to distinguish reasonably available investment alternatives on the basis of pecuniary factors alone. This change effectively leaves in place the "all things being equal" or "tie-breaker" test. Unlike the Proposed Rule, which conditioned use of non-pecuniary factors on investments being "economically indistinguishable," the Final Rule permits fiduciaries to use non-pecuniary factors to make investment decisions when they are "unable to distinguish investment alternatives on the basis of *pecuniary factors* alone." The DOL notes that this change was in response to confusion expressed by commenters about what types of investment characteristics needed to be similar in order to use non-pecuniary factors in making investment decisions.

Notably, the DOL remains skeptical of the "all things being equal" test. The DOL "cautions fiduciaries against too hastily concluding that ESG-themed funds may be selected based on pecuniary factors or are not distinguishable based on pecuniary factors," and notes that it "continues to believe that the likelihood that a plan fiduciary will be unable to distinguish between two investment options based on pecuniary factors is rare." The DOL further cautions that while the Final Rule permits tie-breaker decisions based on non-pecuniary factors, such decisions would still be subject to ERISA's duty of loyalty. Thus, certain tie-breaker decisions that are consistent with the interests of participants and beneficiaries with respect to their retirement income, such as "investments in contribution creating jobs for current or future plan participants," may be consistent with the duty of loyalty. On the other hand, decisions that do not align with such interests, such as those that "would bring greater personal accolades" or be on the "basis of a fiduciary's personal policy preferences," would not comply with the duty of loyalty.

The Final Rule also retains a documentation requirement when non-pecuniary factors are used as a tie-breaker. In this regard, the DOL intends for the documentation requirement to serve as "a safeguard against the risk that fiduciaries will improperly find economic equivalence and make decisions based on non-pecuniary factors without a proper analysis and evaluation." The documentation requirement (which reflects minor changes from the Proposed Rule) provides that if an ERISA fiduciary is unable to determine which investment is in the plan's best interests, the fiduciary may consider non-pecuniary factors to make the decision but must document the following:

1. why pecuniary factors were not sufficient to select the investment or investment course of action;

2. how the investment compares to the alternative investments with regard to the factors listed in [the Final Rule]; and

3. how the chosen non-pecuniary factor or factors are consistent with the interests of the plan's participants and beneficiaries in their retirement income or financial benefits under the plan.

D. Application to Selection of Investment Alternatives in Individual Account Plans

The Final Rule extends to the selection of designated investment alternatives offered to participants in ERISA individual account plans (i.e., as part of an investment menu). Specifically, "when assembling, choosing, or modifying an investment menu for participants' investment choices, a fiduciary must evaluate the designated investment alternatives on the menu based solely on pecuniary factors, not subordinate the interests of participants to unrelated objectives, and not sacrifice investment return or take on additional investment risk to promote non-pecuniary objectives or goals."

The DOL suggests that fiduciaries of individual account plans may need to conduct certain diligence to comply with the Final Rule. Specifically, the DOL cautions that fiduciaries of individual account plans "should carefully review the prospectus or other investment disclosures for statements regarding ESG investment policies and investment approaches" and that they "should be particularly cautious in exercising their diligence obligations under ERISA when disclosures, whether in prospectuses or marketing materials, contain references to non-pecuniary factors or collateral benefits in a fund's investment objectives or goals or its principal investment strategies."

Helpfully, the DOL notes that "plan fiduciaries may consider the express demands or interests of plan Participants" as non-pecuniary factors when applying the "all things being equal" test in such plans.

E. Strict Ban on Use of Non-Pecuniary Factors in QDIAs

Like the Proposed Rule, the Final Rule contains special limitations for QDIAs. Specifically, the Final Rule prohibits an investment alternative from being used as a QDIA "if it, or any of its components, has investment objectives or goals or principal investment strategies that include, consider, or indicate the use of one or more non-pecuniary factors."[3] The DOL clarifies that even if the investment alternative could involve an otherwise permitted use of non-pecuniary factors in accordance with the Final Rule, it would not be permitted to be used as the QDIA.

In justifying its restrictive approach, the DOL notes that a "heightened prophylactic approach for QDIAs is the best course of action." In this regard, the DOL notes that in light of the fact that participants are often defaulted into QDIAs, "it is inappropriate for participants to be defaulted into a retirement savings fund that may have other objectives absent their affirmative decision."

Significantly, the DOL suggests that funds that involve "screening strategies" or other exclusionary strategies, such as the avoidance of certain companies or sectors (e.g., fossil fuels, weapons), may not serve as QDIAs if those strategies involve non-pecuniary factors. The DOL notes that this is because “such an exclusion in an investment alternative’s objectives or principal strategies raises questions as to the extent to which the QDIA’s manager may be foregoing financial returns in pursuit of non-financial objectives.”[4]

II. Effective Date and Extended Compliance Period for QDIAs

The Final Rule is effective 60 days following its publication in the Federal Register. The DOL notes that the Final Rule will apply prospectively, and thus “[p]lan fiduciaries are not required to divest or cease any existing investment, investment course of action, or designated investment alternative, even if originally selected using non-pecuniary factors in a manner prohibited by the final rule.” The Final Rule also provides that the DOL will generally not pursue enforcement regarding compliance with the Final Rule with respect to investment decisions made prior to the effective date but also notes that fiduciaries have a continuing to monitor whether to remain in its ongoing investments. However, the Final Rule also notes that a fiduciary may consider the cost of divestment from a presently existing non-compliant investment when assessing whether the adjusted risk-return of that investment merits keeping it in a plan’s portfolio.

Significantly, unlike the rest of the Final Rule, the special rule for QDIAs is not limited to prospective application. In this regard, the Final Rule provides that plans have up until April 30, 2022 to make changes as needed to comply with the special rule for QDIAs because fiduciaries must modify or divest QDIAs that do not comply with the Final Rule.

The Final Rule also withdraws certain prior DOL guidance. Specifically, the Final Rule withdraws Interpretive Bulletin 2015-1 in its entirety, and notes that the “ESG Investment Considerations” section of Field Assistance Bulletin 2018-1 “will be null and void and will be disregarded by the Department.”

As noted in our previous client alert on this topic, there has recently been an uptick in DOL enforcement activity regarding ESG matters, and the issuance of the Final Rule may amplify those efforts. Relatedly, from a litigation perspective, private litigants may rely on the Final Rule in an attempt to support certain legal theories. In view of these possibilities, fiduciaries may wish to re-examine existing practices (including documentation) in light of the Final Rule’s requirements, and proactively address any enforcement or litigation risks.

III. Conclusion

The Final Rule generally preserves and codifies longstanding principles articulated in prior DOL guidance, although it hews closely to interpretations of ERISA put forth by Republican administrations. Democratic administrations have generally sought a more permissive approach with respect to consideration of ESG factors in investments, so it is likely that a subsequent Democratic administration could revisit the rule or issue clarifying guidance to encourage, for example, ESG investing. Regardless, fiduciaries should be mindful of the Final Rule’s upcoming effective date and proactively address any potential future challenges.