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Key Considerations: DOL's New Final Regulation on ERISA's Investment Duties (ESG-Related or Not)

The U.S. Department of Labor (DOL) finalized amendments to the investment duties of a fiduciary subject to the U.S. Employee Retirement Income Security Act of 1974, as amended (ERISA).[1] The rule amendments were aimed at ERISA fiduciaries that utilize products and strategies that incorporate environmental, social and/or governance (ESG) factors. Though the DOL opted not to let the final rule get bogged down in the ESG-lexicon quagmire by removing all express references to 'ESG,' the final rule clearly and directly applies to fiduciaries that consider ESG factors when investing on behalf of ERISA plans and funds that hold "plan assets." Indeed, *all* ERISA fiduciaries that make investment decisions (including the selection of investment funds for participant-directed plan lineups), *regardless of whether ESG is even implicated*, should review this rule carefully.

The rule becomes effective 60 days after publication in the Federal Register. Plans have until April 30, 2022 to make any changes to their "qualified default investment alternatives" (QDIAs), within the meaning of 29 C.F.R. § 2250.404c-5, as a result of this rule. The rule contemplates a grandfathering mechanism, which will be highly fact-specific.[2] The DOL further noted that it "will not pursue enforcement, and does not believe any private action would be viable, pertaining to any action taken or decision made with respect to an investment or investment course of action by a plan fiduciary prior to the effective date of the final rule to the extent that any such enforcement action would necessarily rely on citation to this final rule."

The final rule builds upon the original investment duties regulation, which provided a safe harbor for fiduciaries in satisfying their duty of prudence under ERISA. The final rule, like the original, compels fiduciaries to give appropriate consideration to numerous factors regarding the composition of the plan portfolio as it relates to diversification, liquidity and current return of the portfolio relative to the anticipated cash flow needs of the plan, and the projected return of the portfolio relative to the funding objectives of the plan. Importantly for 3(38) investment managers, the final rule preserves the aspects of the original regulation that allowed investment managers to rely and act on information provided by the appointing fiduciary in fulfilling these duties with respect to the plan portfolio over which it has discretion.

The final rule withdraws DOL Interpretive Bulletin 2015-01 and supersedes "ESG Investment Considerations" in DOL Field Assistance Bulletin 2018-01.

This final rule does *not* address an ERISA fiduciary's responsibilities with respect to proxy voting and the exercise of other shareholder rights. The DOL recently proposed a rule on this topic, though it has yet to move forward with the proposal. Until a final rule emerges, fiduciaries should continue to follow DOL Interpretive Bulletin 2016-01 and DOL Field Assistance Bulletin 2018-01.

Key Considerations

The final rule preserves the essence of the original investment duties regulation (and ERISA) by allowing ERISA fiduciaries considerable leeway in crafting investment portfolios. The DOL thus admitted that, as a general matter, there is total parity between investment strategies and products, whether ESG-related or not. In other words, an ERISA fiduciary may manage plan assets while taking into account ESG risks and opportunities without violating the rule.

The final rule presents five distinct issues worth considering (1) pecuniary factors; (2) comparing investment alternatives; (3) duty of loyalty; (4) special circumstances/non-pecuniary factors/tie-breakers, and (5) QDIAs.

Pecuniary Factors

Whether investing on behalf of an ERISA-covered defined benefit plan or selecting plan investment options for a participant-directed plan, the final rule compels fiduciaries to consider *pecuniary factors*

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only, absent special circumstances (discussed below), when evaluating the risk and return profiles of investments. The rule defines a "pecuniary factor" as one "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…."[3] The DOL expressly recognized that ESG factors may be pecuniary factors under the rule.[4] The requirement that only pecuniary factors be considered is a legal requirement, not a safe harbor.

The final rule's definition of pecuniary factors is forward-looking in nature, meaning a fiduciary need not know that a factor will materially affect risk/return at the time of the investment. Instead, the fiduciary must be prudent in coming to that conclusion based on the facts and circumstances. This change by the DOL should give comfort to fiduciaries who are closely tracking the emerging data of various ESG (and other) factors' impact on investment performance. Fiduciaries should take note that the DOL has repeatedly cautioned fiduciaries against disproportionately weighting the materiality of a factor based on existing data.

The DOL opted to avoid defining the slippery concept of materiality. The DOL said in the preamble to the final rule that it "believes that fiduciaries and investment managers are generally familiar with that concept from its use in connection with both ERISA and the federal securities laws." This seemingly allows the concept of pecuniary factors to evolve with market consensus on materiality and ultimately on how other regulators define materiality for these purposes. Yet, the DOL acknowledged that the following may be material, and thus, pecuniary factors under the rule: (1) an investment manager's brand/reputation; (2) proprietary products; and (3) a fund or product's legal regime that confers greater investor protection and/or improved disclosures.

As with any other evaluation of prospective investments, a fiduciary should first determine that it has sufficient skills and expertise to determine that the ESG (or any other) factor presents economic risks or opportunities that qualified investment professionals would treat as material economic considerations under generally accepted investment theories (if not, the determination should be made by another fiduciary that has such expertise and skill).[5] Moreover, the DOL apparently will look for risk controls in place commensurate with the complexity, nature and size of the investment activity (the implication is that fiduciaries that consider ESG factors should have rigorous controls in place to ensure that they are properly determining factors to be pecuniary factors under the rule).

In the context of ERISA-covered participant-directed plans, the decision as to which funds populate the plan lineup is subject to ERISA's fiduciary duties and this new rule, among others. In the preamble to the final rule, the DOL addressed whether a fiduciary could select an ESG investment fund, product or model portfolio based solely on participant request or because of the potential for increased contributions to the plan. In short, these types of considerations are *not* pecuniary factors and, therefore, the responsible fiduciary may not base its decision to include an ESG fund, product or model portfolio as a designated investment alternative without separately determining that the pecuniary reasons for such inclusion satisfy the rule. As discussed below, however, participant requests and the like may be "tie-breakers" in selecting between alternative investment options.

<u>Comparing Investment Alternatives</u>

Under the final rule, the fiduciary must compare investments or investment courses of action (*e.g.*, selection of designated investment alternative for participant-directed plans) based on factors "that are expected to result in a material difference among reasonably available alternatives with respect to risk and/or return." This comparison requirement is, therefore, not limitless. Thus, a fiduciary does not need to consider *all* factors that differentiate investment funds, only ones that are pecuniary. Moreover, fiduciaries are under no obligation to scour the market for the lowest cost investment opportunities, much less select the cheapest available investments.

The DOL further confirmed that the fiduciary need not expend considerable resources on searching for investment opportunities or considering an infinite number of investment alternatives. Instead, the fiduciary's duty to evaluate alternative investment opportunities is limited to comparing alternatives that are reasonably available under the circumstances. This means that the rule "allow[s] for the possibility that the characteristics and purposes served by a given investment…may be sufficiently rare that a fiduciary could prudently determine, and document, that there were no other reasonably available alternatives for purposes of this comparison requirement."

<u>Duty of Loyalty</u>

Fiduciaries are already well aware that ERISA imposes a duty of loyalty, in addition to the prudence requirements discussed above. The final rule incorporates this specific fiduciary duty by prohibiting fiduciaries from subordinating the interests of plan participants and beneficiaries in their retirement income to non-pecuniary goals. Though this may seem to be an example of form over function, the DOL opted not to include the duty of loyalty under the rule's general safe harbor characterization, meaning fiduciaries will likely not only be conservative in satisfying the rule's requirements but may also opt for even stronger controls/analysis/documentation than the rule technically requires to ensure they do not run afoul of the loyalty concerns the DOL has expressed in the context of ESG.

<u>Special Circumstances/Non-Pecuniary Factors/Tie-Breakers</u>

Prior DOL guidance provided that if, after an evaluation, alternative investments appear economically indistinguishable, a fiduciary may then, in effect, "break the tie" by relying on a non-pecuniary factor. Commenters argued that the proposal effectively required equivalence between investments. The DOL suggested that they did not mean for investment alternatives to have *identical* characteristics, just equivalent roles in the plan's investment portfolio. Commenters argued that indistinguishability in liquid markets is all but impossible and are, in turn, never perfectly correlated.

Under the final rule, if a fiduciary is unable to determine which investment is in the best interests of the plan on the basis of pecuniary factors alone, the fiduciary may base the investment decision on non-pecuniary factors, provided the fiduciary documents the following: (1) why pecuniary factors were not sufficient to select the investment; (2) how the investment compares to the alternative investments; and (3) how the chosen non-pecuniary factors are consistent with the interests of the participants and beneficiaries in their retirement income or financial benefits under the plan. This effectively prohibits ERISA fiduciaries from choosing investments with expected reduced returns or enhanced risks in order to secure non-pecuniary benefits.

The third condition is a hemmed-in version of the historical tie-breaker test. Simply, the DOL split the difference from the proposal, which all but eliminated the tie-breaker mechanism, and instead has allowed a tie-breaker but only on the basis of a *pecuniary-light* factor. Under the final rule, a fiduciary no longer appears able to select an investment fund based on the ethos of the plan sponsor (assuming the other conditions of the rule are met). Instead, the non-pecuniary factor must at least have some nexus to participants' and beneficiaries' retirement income or financial benefits. The DOL indicated that responding to participant demand in order to increase retirement plan savings may be consistent with the interests of the participants and interests in their retirement income or financial benefits under the plan. In contrast, selecting an investment option that "would bring greater personal accolades to the chief executive officer of the sponsoring employer, or solely on the basis of a fiduciary's personal policy preferences, would not."

The same standards apply to selecting investment funds, products and model portfolios for a participant-directed plan lineup. The DOL admonished fiduciaries to "carefully review the prospectus or other investment disclosures for statements regarding ESG investment policies and investment approaches." In particular, the DOL stressed that fiduciaries should be "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."

The DOL envisions that fiduciaries will evaluate fund prospectuses and other disclosures to determine if the fund uses an ESG or sustainability rating system of index. If the fund uses such a rating system or index, the fiduciary, as part of its due diligence, would need to consider whether the rating system or index "evaluates one or more factors that are not financially material to investments." If so, the selection of the fund is a special circumstance, thereby requiring the fiduciary to satisfy the aforementioned heightened requirements.

On this point, the DOL indicated that a fiduciary would have to understand how the ratings are actually determined, such as the rating's methodology, weighting, data sources, performance benchmarks and the underlying assumptions utilized. Moreover, "a fiduciary may not assume that combining [multiple factors] into a single rating, index or score creates an amalgamated factor that is itself pecuniary."

<u>QDIAs</u>

On QDIAs, DOL stressed that the proposal was never intended to block investment funds, products or model portfolios that treat ESG factors as pecuniary in nature from being QDIAs. The final rule better captures this intent by only prohibiting those QDIAs whose investment objectives, goals or principal investment strategies include, consider or indicate, one or more non-pecuniary factors. Crucially, the tie-breaker mechanism is not available when selecting QDIAs. This means that a fund will no longer qualify as a QDIA if its investment objectives, goals or principal strategies include a non-pecuniary factor, even if including such fund as a QDIA is in response to participants' request or otherwise increase the desirability of the plan to participants.

The DOL claimed fiduciaries can apply the rule to QDIAs easily and objectively. They indicated, for example, that a plan fiduciary can simply look at the investment fund's prospectus to determine whether the fund is qualified or disqualified as a QDIA under the final rule. The DOL specifically pointed to Form N-1A to ascertain whether non-pecuniary considerations form a material part of a fund's investment objectives or principal strategies. The DOL is under the impression that disclosures for other types of investment vehicles, such as collective investment trusts and insurance separate accounts, would provide sufficient information for these purposes.

As noted above, the DOL envisions fiduciaries evaluating fund prospectuses and other disclosures to determine if the fund uses an ESG or sustainability rating system of index. Again, if the fund uses such a rating system or index, the fiduciary, as part of its due diligence, would need to consider whether the rating system or index "evaluates one or more factors that are not financially material to investments." If so, the fund would no longer qualify as a QDIA under the final rule.

Funds that use positive or negative screening may similarly result in their disqualification as a QDIA, if the screening involves non-pecuniary factors that effectively results in the exclusion of certain sectors or categories of investments, and such exclusions are reflected in the fund's investment objectives or principal strategies. If these exclusions are *not* reflected in the investment alternative's objectives or principal strategies, but they are otherwise disclosed, the fiduciary evaluating such fund is expected to undertake "an economic analysis of the economic consequences to the plan of such an exclusion and determining that such an exclusionary policy would not be economically harmful to the plan."

The regulation does not apply to investment alternatives that are not designated investment alternatives under the plan (*e.g.*, brokerage windows). However, DOL noted that the rule should not be construed as addressing the application of ERISA's duties of prudence and loyalty to brokerage windows or other non-designated investment alternatives that grant participants and beneficiaries access to investments that are not designated investment alternatives, and suggests there may be future rulemaking to address this.

Other Considerations

The DOL responded to concerns that the regulation may redirect or stall the development of ESG practices, particularly as the U.S. Securities and Exchange Commission (SEC) continues to monitor ESG developments. Commenters pointed to the SEC's recent solicited public comment request on the "Names Rule" under the U.S. Investment Company Act of 1940, as amended. The DOL noted in the preamble to the final rule that it did not think it needed to delay a final rule until the SEC decides to take action on the Names Rule. The DOL also recognized that some financial regulators are looking at whether ESG risk presents systemic risk to the financial markets. The DOL responded, "if financial regulators adopt new rules or policies that affect financial market participants, that may create pecuniary or non-pecuniary considerations for plan fiduciaries apart from ERISA." It isn't entirely clear what the DOL meant by this. One interpretation is that other regulators' interpretation of *materiality* can inform an ERISA fiduciary's determination as to whether a particular factor is pecuniary or not under the final rule. Yet a contrary interpretation is that the DOL, by using the language "apart from ERISA," intends to largely wall off the final rule from other regulators' potentially increasing liberalization over what factors are material to investment return and risk.

The DOL likewise responded to commenters who raised concerns that this rulemaking would interfere with how other federal agencies were addressing ESG risks. For example, the DOL acknowledged that the State Department, Treasury Department, Commerce Department and Department of Homeland Security have taken positions on supply chain links to entities that engage in human rights abuses, including, for example, forced labor in China. Even though supply chain risk is an ESG factor, the DOL took the position that it sees no fundamental conflict between this final rule and positions regarding supply chain risk raised by other government agencies.

Somewhat relatedly, the DOL responded to a comment that the rule would conflict with the position it took regarding the federal Thrift Savings Plan (TSP), namely, to prohibit the plan from investing in Chinese equities. While noting that the TSP is not covered by Title I of ERISA, the DOL added that its "position with respect to investments in China was informed by consideration of specific matters relating to investment risk, including inadequate investor disclosures and legal protections, that are consistent with "pecuniary factors" as used in the final rule." The DOL further added that "other concerns were raised because the Federal Government matches TSP contributions and investments in China might result in the Federal Government funding activities that are opposed to U.S. national security interest." Its first explanation, namely that it found disclosures related to Chinese holdings insufficient and legal protections were insufficient, is noteworthy for all ERISA fiduciaries because the final rule states that sufficiency of disclosures and legal protections are pecuniary factors. Thus, a fiduciary may wish to exercise caution in how it evaluates and documents the pecuniary factors in deciding on an investment that has Chinese holdings in light of the DOL's concern.

The DOL dismissed concerns that the final rule would conflict with international ESG rules and trends by dismissing the sheer relevance of such trends and non-U.S. rules. Specifically, the DOL stated, "international trends in the consideration of ESG factors or other actions of regulators in other countries are not an appropriate gauge for evaluating ERISA's requirements as they apply to investments of ERISA-covered employee benefit plans."

The final rule is not immune to rescission or change by Congress or the DOL under a future administration.

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[1] 29 C.F.R. § 2550.404a-1.

[2] In a footnote to the preamble of the final rule, the DOL stated, "[t]he Department notes that it may be that a fiduciary could prudently determine that the expected return balanced against the costs and risks of loss associated with divesting an investment made before the effective date of the rule are such that continuing to hold that investment would be appropriate even if the fiduciary as part of its monitoring process determined that the investment, or aspects of the decision-making process, does not comply with the final rule."

[3] The proposal's language seemingly required that, before an ERISA fiduciary could treat an ESG or other factor as a pecuniary factor, the ESG or other factor would already have had to be determined by other investment professionals as being material to investment performance.

[4] In the preamble to the final rule, the DOL noted, for example, that "a company's improper disposal of hazardous waste would likely implicate business risks and opportunities, litigation exposure, and regulatory obligations" and that "[d]ysfunctional corporate governance can likewise present pecuniary risk that a qualified investment professional would appropriately consider on a fact-specific basis."

[5] The DOL indicated that it does not intend the term "generally accepted investment theories" to freeze the evolution of investment theory or practice, but rather "to establish a regulatory guardrail against situations in which plan investment fiduciaries might be inclined to use…policy-based metrics in their assessment of the pecuniary value of an investment or investment plan that are inherently biased toward inappropriate overestimations of the pecuniary value of policy-infused investment criteria."