



WR Marketplace

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Topic: Takeaways from the DOL’s Final Rule on Selecting ESG-Focused Plan Investments

Market trend: The Department of Labor (“DOL”) issued a final rule (the “Final Rule”) under the Employee Retirement Income Security Act of 1974, as amended (“ERISA”), reinforcing the DOL’s position that when making decisions about investment alternatives in 401(k) plans (and other investment actions), a plan fiduciary must focus solely on the “pecuniary interests” of plan participants and beneficiaries.¹ The Final Rule will impact 401(k) plans that currently include investment choices themed around environmental, social and governance (“ESG”) investment goals and likely creates higher hurdles for fiduciaries when considering and monitoring ESG-themed investment choices. The Final Rule largely follows the proposed rules published in June 2020, but in response to public comments it does soften certain provisions.

Synopsis: The Final Rule updates the “investment duties” regulation under ERISA in several key respects that will impact the offering of ESG-themed investments in 401(k) plans. The Final Rule confirms that ERISA fiduciaries must evaluate plan investments based solely on “pecuniary factors,” and failure to do so can be considered a breach of ERISA’s duty of loyalty. When selecting plan investments, the fiduciary also must consider “reasonably available

¹ Here is a link to the Final Rule: <https://www.dol.gov/sites/dolgov/files/ebsa/temporary-postings/financial-factors-in-selecting-plan-investments-final-rule.pdf>

alternatives.” If multiple investment alternatives under consideration cannot be distinguished based solely on pecuniary factors, certain non-pecuniary factors may be used as a tie-breaker, subject to certain documentation requirements. However, an investment fund that expressly includes non-pecuniary goals in its stated goals and objectives is prohibited from being included as part of a plan’s “qualified default investment alternative” (or “QDIA”).

Takeaways: The Final Rule will become effective 60 days after the date of publication in the Federal Register and will apply prospectively to investment decisions made after that date. The Final Rule also gives plans until April 30, 2022 to make any changes necessary to comply with the requirements related to the selection of QDIAs. The Final Rule will likely make it harder for fiduciaries to include ESG-themed investments in their plan’s investment portfolio and fiduciaries should review their investments and investment policies to determine if any changes need to be made. Given the speed at which the Final Rule was developed and the significant opposition expressed during the rulemaking comment period, it is likely to be challenged in the courts.

Given the continued rise in investments focused on ESG goals, the DOL found it necessary to issue guidance to lay out the standards for plan fiduciaries in selecting investments and to provide clarifying guideposts for considering non-pecuniary objectives, which may include certain ESG objectives. Over the years, the DOL has been asked to comment on whether ESG-themed investments comply with ERISA’s fiduciary duties for selecting investments and investment courses of action. Such duties require plan fiduciaries to, among other things:

- act solely in the interest of plan participants and beneficiaries and for the exclusive purpose of providing benefits to participants and beneficiaries and defraying reasonable expenses of administering the plan – sometimes referred to as ERISA’s “duty of loyalty”; and
- act with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims – sometimes referred to as ERISA’s “duty of prudence.”

The DOL’s chief concern with respect to ESG investments “is the lack of precision and consistency in the marketplace with respect to defining ESG investments and strategies, as well as shortcomings in the rigor of the prudence and loyalty analysis by some participating in the ESG investment marketplace.... Moreover, ESG funds often come with higher fees, because additional investigation and monitoring are necessary to assess an investment from an ESG perspective.”

The DOL noted that it has provided sub-regulatory guidance through the years on the permitted use of “non-pecuniary factors” in making investment decisions for ERISA plans, and that this guidance has not always been consistent or clear. To address these concerns through formal regulations, the DOL issued a proposed rule (the “Proposed Rule”) in June 2020 to provide the

standards for plan fiduciaries in determining investments and investment courses of action based on non-pecuniary factors such including ESG goals. The Proposed Rule made five key changes to the ERISA investment duties regulation, which include:

- the requirement that plan fiduciaries must select investments and investment courses of action based on financial considerations relevant to the risk-adjusted economic value of a particular investment or investment course of action;
- the addition of the ERISA fiduciary duty of loyalty to prohibit fiduciaries from subordinating the interests of plan participants and beneficiaries in retirement income and financial benefits to non-pecuniary goals;
- the requirement that fiduciaries to consider other available investments to meet their prudence and loyalty duties under ERISA;
- the addition of a required investment analysis and documentation requirement if fiduciaries use non-pecuniary factors when choosing among economically indistinguishable investments; and
- additional considerations for selecting QDIAs for 401(k) plans.

Although the DOL provided an accelerated comment period and no public hearings, the Proposed Rule generated thousands of comments, mainly in opposition, from interested stakeholders, including asset managers, plan sponsors and individual plans.

Overview of Final Rule

The following describes the key provisions of the Final Rule, including key modifications from the Proposed Rule:

“Pecuniary Factors” Are the Key

The Final Rule does not include any references to ESG or its component “environmental,” “social” or “governance” factors. The DOL recognized that the concepts around what constitutes ESG-themed investments or objectives is not well defined and constantly evolving. Also, the DOL acknowledged certain comments it received that, in some cases, ESG-related objectives for some investment choice may in fact serve participant financial interests. So, instead of referencing ESG, the Final Rule focuses on those factors in a fiduciary’s decision that are “pecuniary factors” v. “non-pecuniary factors.” The Final Rule provides that “pecuniary factors” are necessary and appropriate for ERISA fiduciaries to consider, while “non-pecuniary factors” are sometimes permissible for certain “tie-breaking” decisions, but otherwise not allowed. As discussed below, it may be possible for ESG-related goals to be considered “pecuniary factors” in certain circumstances as determined by the plan fiduciary, but the DOL commentary in the preamble to the Final Rule suggests that such determinations may be met with skepticism and likely require solid documentary support.

Safe Harbor Rules Regarding Duty of Prudence

The ERISA investment duties regulation originally included guidance regarding ERISA's duty of prudence that has served as a safe harbor for compliance. Comments received on the Proposed Rule were concerned that the changes would cause these duty of prudence requirements to become rigid, mandatory rules rather than a more flexible safe harbor. The comments also raised the concern that the Proposed Rule blended in duty of loyalty requirements in a confusing manner. The Final Rule preserves the safe harbor nature of the duty of prudence requirements and separately lays out new duty of loyalty requirements in a separate section (discussed below).

The Proposed Rule added a requirement related to the duty of prudence that fiduciaries consider how “the investment or investment course of action compares to available alternative investments or investment courses of action....” During the comment period, commenters expressed concern over the extent to which a plan sponsor would be required evaluate alternatives. In the preamble to the Final Rule, the DOL states that the requirement was not intended to require fiduciaries to “scour the market” or evaluate every potential alternative.

The Final Rule clarifies that a fiduciary will satisfy the duty of prudence when considering whether a particular investment or investment course of action is “reasonably designed” by “taking into consideration the risk of loss and the opportunity for gain (or other return) associated with the investment or investment course of action compared to the opportunity for gain (or other return) associated with reasonably available alternatives with similar risks.” The use of the phrase “reasonably available alternatives” makes it clear that fiduciaries are only required to compare alternatives that are reasonably available under the circumstances.

Clarifying the Duty of Loyalty

In both the Proposed Rule and the Final Rule, the DOL believed it necessary to specifically include the elements of the duty of loyalty in the investment duties regulation. In the DOL's view, ERISA's duty of loyalty has always required “fiduciaries to focus investment decision-making on providing financial benefits to participants under the plan and prohibits fiduciaries from subordinating the interests of participants and beneficiaries in their retirement income or financial benefits under the plan to unrelated objectives.”

As mentioned, the Proposed Rule included factors related to the duty of loyalty in the section of the rule that also addressed the duty of prudence, leading to confusion and much criticism in the public comments. The Final Rule separates out the duty of loyalty requirement, and expresses it as a mandate, not merely a safe harbor. In particular, the Final Rule sets forth three requirements for selection of investments:

- A fiduciary's evaluation of an investment or investment course of action must be based only on pecuniary factors.
- A fiduciary may not subordinate the interests of the participants and beneficiaries in their retirement income or financial benefits under the plan to other objectives.

- A fiduciary may not sacrifice investment return or take on additional investment risk to promote non-pecuniary benefits or goals.

The DOL recognized that there may be instances where ESG factors could be treated as pecuniary factors, such as when they present a “material business risk or opportunities to companies that company officers and directors need to manage as part of the company’s business plan and that qualified investment professionals would treat as economic considerations under generally accepted investment theories.” In recognition of these instances, the Final Rule modifies the definition of “pecuniary factor” to mean “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.” Under the revised definition, it is now in the hands of the fiduciary to determine whether a particular factor is pecuniary.

The “All Things Being Equal” Test

In limited circumstances where fiduciaries are unable to distinguish between reasonably available investments options based solely on the pecuniary factors, the Final Rule allows fiduciaries to consider non-pecuniary factors.

If the fiduciary does incorporate a non-pecuniary factor to “break the tie,” then he or she must document the following:

- why pecuniary factors were not sufficient to select the investment or investment course of action;
- how the selected investment compares to the alternative investments with regard to composition, liquidity, and returns of the plan’s portfolio; and
- how the non-pecuniary factor or factors were chosen based upon the purposes of the plan, the diversification of investments, and the interests of the participants and beneficiaries in receiving benefits from the plan.

The DOL notes this documentation requirement is included as a safeguard against the risk that fiduciaries will make a decision based on non-pecuniary factors without a proper analysis and evaluation of each investment on its pecuniary factors.

Some commenters observed that participants in 401(k) plans want to be able to select ESG-themed funds, and that offering those ESG-themed funds could increase plan participation. While the DOL acknowledged that increased plan participation may be a worthy goal, it does not constitute a “pecuniary factor.” Therefore, under the Final Rule it would be relevant only in the case of considering a “break the tie” decision.

Selection of Designated Investment Alternatives in 401(k) Plans and Restrictions on QDIAs

The Final Rule clarifies that the same duties of prudence and loyalty that apply when evaluating investments, also apply to a fiduciary's evaluation and selection of designated investment alternatives in a 401(k) plan. In particular, the Final Rule notes, "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."

Since the requirement that alternatives may only be added if they can be justified based on pecuniary factors the DOL encourages fiduciaries to "carefully review the prospectus or other investment disclosures for statements regarding ESG investment policies and investment approaches" and to use caution when a prospectus contains references to non-pecuniary factors so as not to run afoul with their fiduciary obligations.

The Final Rule, however, provides that brokerage windows and self-directed brokerage accounts are not "designated investment alternatives" that are within the scope of the Final Rule. Decisions about whether to offer a brokerage window or self-directed brokerage account remain subject to general ERISA fiduciary requirements, however.

The Final Rule maintains the restrictions set forth in the Proposed Rule with regard to QDIAs. The Final Rule explicitly provides that plans are prohibited from adding or retaining any investment fund, product, or model portfolio as a QDIA, or as a component of such a default investment alternative, if its objectives or goals or its principal investment strategies include, consider, or indicate the use of one or more non-pecuniary factors.

Effective Date and Next Steps

The Final Rule becomes effective 60 days after publication in the Federal Register and will apply prospectively to any investment decisions made after the effective date. As a result, any existing investment or investment course of action, or designated investment alternative, even if originally selected in violation of Final Rule will not be required to be immediately removed, but may be subject to later action as investment performance is monitored. Additionally, the Final Rule gives plans until April 30, 2022 to make any changes to their QDIA in the event it utilizes a fund with a non-pecuniary factor.

Given the amount of criticism that the Proposed Rule received and the accelerated process by which the Final Rule was adopted, it will not be surprising if the Final Rule is challenged. Any decision by the DOL under a new administration to reverse the Final Rule, however, would have to follow administrative law procedures given it has been finalized. In the meantime, 401(k) plan fiduciaries should review their existing investment fund line-up in light of the standards in the Final Rule, especially if any fund that is part of the plan's QDIA includes non-pecuniary investment goals and strategies.