TRUCKER ✦ HUSS

BENEFITS REPORT

Special Alert

CELEBRATING 40 YEARS
1980 – 2020

SPECIALIZED TALENT & EXPERTISE TO SOLVE THE MOST COMPLEX AND SOPHISTICATED CLIENT CHALLENGES.

With more than 25 attorneys practicing solely in employee benefits law, Trucker Huss is one of the largest employee benefits specialty law firms in the country. Our in-depth knowledge and breadth of experience on all issues confronting employee benefit plans, and their sponsors, fiduciaries and service providers, translate into real-world, practical solutions for our clients.

A DIVERSE CLIENT BASE. We represent some of the country's largest companies and union sponsored and Taft-Hartley trust funds. We also represent mid-sized and smaller employers, benefits consultants and other service providers, including law firms, accountants and insurance brokers.

PERSONAL ATTENTION AND SERVICE, AND A COLLABORATIVE APPROACH. Since its founding in 1980, Trucker Huss has built its reputation on providing accurate, responsive and personal service. The Firm has grown in part through referrals from our many satisfied clients, including other law firms with which we often partner on a strategic basis to solve client challenges.

NATIONALLY-RECOGNIZED. Our attorneys serve as officers and governing board members to the country's premier employee benefits industry associations, and routinely write for their publications and speak at their conferences.

TRUCKER ✦ HUSS

A PROFESSIONAL CORPORATION

ERISA AND EMPLOYEE BENEFITS ATTORNEYS

One Embarcadero Center, 12th Floor
San Francisco, California 94111-3617

15821 Ventura Blvd, Suite 510
Los Angeles, California 91436-2964

Tel: (415) 788-3111
Fax: (415) 421-2017
Email: info@truckerhuss.com

www.truckerhuss.com

A Pecuniary Focus: Department of Labor Issues Final Rule on Financial Factors in Selecting Plan Investments

ROBERT R. GOWER

NOVEMBER 2020

On October 30, 2020, the Department of Labor (DOL) issued a final rule (the "Final Rule") amending the investment duties regulation under Section 404(a) of the Employee Retirement Income Security Act of 1974 (ERISA). The significant and much-anticipated Final Rule updates the existing investment duties regulation framework to provide minimum standards a fiduciary must meet in order to satisfy ERISA's duty of loyalty in selecting plan investments.

The Final Rule comes after years of DOL sub-regulatory guidance focused on the appropriateness of plan investment options that aim to achieve collateral economic or social benefits in addition to investment returns (commonly referred to as environmental, social and governance [ESG] investments). Over the last several years, the DOL has expressed increasing concern that a growing emphasis and interest in ESG investing may prompt ERISA plan fiduciaries to make investment decisions for motives *other* than their fiduciary duty to provide benefits to participants and beneficiaries, and defray reasonable expenses of administering a plan. As was widely anticipated, the Final Rule focuses on this concern, and it formalizes the DOL's longstanding position that when making decisions on investments and investment courses of action (defined as any series or program of investments or actions related to a fiduciary's performance of the fiduciary's investment duties), plan fiduciaries should focus solely on pecuniary factors.

Overview of Final Rule

The Final Rule amends the existing investment duties regulation to more directly address ERISA's fiduciary duty of loyalty by providing specific minimum standards that a fiduciary must adhere to in order to satisfy that duty when selecting investments or investment courses of action. Specifically, the Final Rule provides:

- The fiduciary duty of loyalty is satisfied where an investment or investment course of action is based solely on pecuniary factors, and fiduciaries do not subordinate the interests of participants and beneficiaries in their retirement income or financial benefits under the plan to other objectives. The DOL defines a "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 funding policy.

- Where (and only where) an investment or investment course of action cannot be distinguished based upon pecuniary factors alone, the fiduciary may use non-pecuniary factors as decisive in the investment decision, provided that the fiduciary documents (1) why pecuniary factors were not sufficient to select the investment or investment course of action; (2) how the selected investment compares to alternative investments with respect to diversification, risk and/or return, liquidity, time horizons, and the plan's investment objectives and policy; and (3) how the chosen non-pecuniary factor or factors are consistent with the interests of participants and beneficiaries in their retirement income or financial benefits under the plan. Notably, in permitting the consideration of non-pecuniary factors under such limited circumstances, the DOL states that a situation in which a plan fiduciary will be unable to distinguish between two investment options based on pecuniary factors alone is rare, highlighting that the DOL will scrutinize the use of any non-pecuniary factors.

- Qualified Default Investment Alternatives (QDIAs), which serve as default funds in participant-directed plans, may *not* consider non-pecuniary factors. Specifically, the Final Rule prohibits fiduciaries from selecting a fund as a QDIA if the fund, or any of its components, has investment objectives, goals or principal investment strategies that include, consider, or indicate the use of one or more non-pecuniary factors. This prohibition remains even if the investment cannot otherwise be distinguished based upon pecuniary factors alone. Importantly, the DOL highlighted "screening strategies" (the act of screening and excluding from a fund certain sectors or companies involved in activities deemed unacceptable or controversial, such as investments in companies engaged in the production or distribution of alcohol, tobacco, fossil fuels, weapons, or gaming) as an example of a factor that would most likely be non-pecuniary and, therefore, unacceptable as a component of a QDIA. The DOL supports its strict position prohibiting consideration of non-pecuniary factors under any circumstances in selecting a QDIA by explaining that it believes it would be inappropriate to default participants into any investment with objectives other than pecuniary objectives without their consent.

In addition to introducing minimum standards to satisfy the fiduciary duty of loyalty, the Final Rule makes it clear that the fiduciary duty of prudence only requires fiduciaries to consider *reasonably available* alternatives when evaluating investment options. This standard clarifies that fiduciaries are not required to scour the market or consider every possible investment alternative, and it allows for the possibility (however unlikely) that the characteristics and purposes served by a given investment or investment course of action may be sufficiently rare that a fiduciary could prudently determine, and document, that there were no other reasonably available alternatives.

Impact of the Final Rule

The significance of the Final Rule cannot be overstated. While plan fiduciaries have long awaited formal guidance from the DOL with respect to ESG considerations in selecting investments and investment courses of actions, there are understandably sensitivities in regulating around ESG investing, often driven by the desires of participants to invest in line with their moral and/or social beliefs. In fact, the DOL received over 1,100 written comments on its proposal prior to issuing the Final Rule. Even in the wake of these comments and concerns, the DOL's position remains clear: that ERISA's fiduciary duty of loyalty requires plan investment focus to be on pecuniary factors, and the financial interests of participants or beneficiaries may not be subordinated to other motives (even at their own request).

It is worth noting that, unlike prior guidance from the DOL related to ESG investing, the DOL deliberately refrained from referring to ESG in the Final Rule, instead focusing on the concept of non-pecuniary factors. By focusing on non-pecuniary factors, the DOL is able to more broadly address its concerns over subordinating financial interests for other motives, and it avoids having to define ESG. Nevertheless, given current industry trends and increased interest in ESG investing, the Final Rule should be understood to directly impact ESG investing. The DOL makes it clear in the preamble to the Final Rule that ESG investing was a primary motive behind the new regulatory framework, and it will continue to be an area of ongoing focus and review.

Under the Final Rule, plan fiduciaries will face an uphill and defensive battle in adding an ESG investment or investment course of action to a plan. In order to adequately demonstrate fiduciary due-diligence, a pecuniary focus and thorough documentation process must be maintained throughout the entire investment process. For plan fiduciaries to satisfy their duty of loyalty, any ESG components of an investment or investment course of action should be evidenced and documented as having been considered for pecuniary motives. Furthermore, a comparison of reasonably available alternatives must be conducted in order to establish that the selection of the investment with an ESG component was prudent. By way of example, if an investment alternative under consideration focuses on clean energy, the plan fiduciaries in consultation with the plan's investment professionals must evidence and document that they are selecting the clean energy fund for pecuniary reasons (i.e., because they believe that a clean energy fund will perform better over time than other energy funds without a clean energy focus, and that the selected clean energy fund will perform better than other clean energy funds); and then the fiduciaries must also conduct and document a comparison of reasonably available alternatives in order to establish that the investment is a prudent choice.

While the DOL has stated that, under the limited circumstances where an investment or investment course of action cannot be distinguished based upon pecuniary factors alone, the fiduciary may use non-pecuniary factors as decisive in the investment decision, the DOL has also made clear that it believes such indistinguishable circumstances are rare. For this reason, plan fiduciaries should anticipate significant scrutiny of any investment decision or investment course of action that applies non-pecuniary factors as decisive. With this in mind, plan fiduciaries who are unable to avoid applying non-pecuniary factors in making an investment decision must thoroughly document why pecuniary factors were not sufficient to select the investment or investment course of action and how the chosen non-pecuniary factor or factors remain consistent with the interests of participants and beneficiaries in their retirement income or financial benefits.

Finally, because the Final Rule prohibits a fund 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 (including screening factors), plan fiduciaries must ensure that a QDIA has been selected based solely on pecuniary factors. This restriction does not entirely prohibit the use of an ESG fund as a QDIA, but it does substantially decrease the likelihood by prohibiting the use of a non-pecuniary factor as decisive where potential alternative QDIAs cannot be distinguished based upon pecuniary factors alone. Simply put, the use of an ESG fund, or fund with an ESG component, as a QDIA must be defensible on pecuniary factors alone.

Compliance Deadlines and the Road Ahead

The Final Rule generally becomes effective 60 days after imminent publication in the Federal Register. The DOL notes that the Final Rule will apply prospectively, and that plan 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. However, after the effective date, all decisions regarding such investments, investment courses of action, or designated investment alternatives, including decisions that are part of a fiduciary's ongoing monitoring requirements, must comply with the Final Rule. In effect, this means a plan fiduciary will not be penalized for their prior motives in adding funds with ESG components, but existing funds with ESG components must be reviewed for continued appropriateness under the new minimum standards that a fiduciary must apply in order to satisfy their duty of loyalty.

The Final Rule does provide for a lengthier grace period for review and divestment of QDIAs that consider non-pecuniary factors. Plan fiduciaries have until April 30, 2022, to review and divest of any such investments under a participant-directed plan.

Finally, it is worth noting that while the results of the November 3, 2020, presidential election will usher in a new Democratic administration, which may show more willingness to strike a balance between achieving pecuniary motives and a participant's desire to achieve certain social and/or moral objectives with their retirement savings, the Final Rule generally becomes effective 60 days after its November 13, 2020, publication in the Federal Register. As a result, even if the new administration desires to modify the Final Rule, it will be a lengthy process, leaving the Final Rule as an enforceable regulation for an extended period of time.

The Trucker ✦ Huss *Benefits Report* is published monthly to provide our clients and friends with information on recent legal developments and other current issues in employee benefits. Back issues of *Benefits Report* are posted on the Trucker ✦ Huss web site (www.truckerhuss.com).

Editor: Shannon Oliver, soliver@truckerhuss.com

TRUCKER ✦ HUSS

Adrine Adjemian
aadjemian@truckerhuss.com
415-277-8012

Jahiz Noel Agard
jagard@truckerhuss.com
415-277-8022

Bryan J. Card
bcard@truckerhuss.com
415-277-8080

Lindsay R. Docto
ldocto@truckerhuss.com
415-277-8030

Joseph C. Faucher
jfaucher@truckerhuss.com
213-537-1017

J. Marc Fosse
mfosse@truckerhuss.com
415-277-8045

Angel Garrett
agarrett@truckerhuss.com
415-277-8066

Robert R. Gower
rgower@truckerhuss.com
415-277-8002

R. Bradford Huss
bhuss@truckerhuss.com
415-277-8007

Clarissa A. Kang
ckang@truckerhuss.com
415-277-8014

Sarah Kanter
skanter@truckerhuss.com
415-277-8053

T. Katuri Kaye
kkaye@truckerhuss.com
415-788-3111

Freeman L. Levinrad
flevinrad@truckerhuss.com
415-277-8068

Elizabeth L. Loh
eloh@truckerhuss.com
415-277-8056

Gisue Mehdi
gmehdi@truckerhuss.com
415-277-8073

Brian D. Murray
bmurray@truckerhuss.com
213-537-1016

Kevin E. Nolt
knolt@truckerhuss.com
415-277-8017

Yatindra Pandya
ypandya@truckerhuss.com
415-277-8063

Barbara P. Pletcher
bpletcher@truckerhuss.com
415-277-8040

Mary Powell
mpowell@truckerhuss.com
415-277-8006

Catherine L. Reagan
creagan@truckerhuss.com
415-277-8037

Dylan D. Rudolph
drudolph@truckerhuss.com
415-277-8028

Tiffany N. Santos
tsantos@truckerhuss.com
415-277-8039

Robert F. Schwartz
rschwartz@truckerhuss.com
415-277-8008

Charles A. Storke
cstorke@truckerhuss.com
415-277-8018

Jennifer Truong
jtruong@truckerhuss.com
415-277-8072

Nicholas J. White
nwhite@truckerhuss.com
415-277-8016

PARALEGALS

Shannon Oliver
soliver@truckerhuss.com
415-277-8067

Susan Quintanar
squintanar@truckerhuss.com
415-277-8069

TRUCKER ✦ HUSS
A PROFESSIONAL CORPORATION
ERISA AND EMPLOYEE
BENEFITS ATTORNEYS

One Embarcadero Center, 12th Floor
San Francisco, California 94111-3617

15821 Ventura Blvd, Suite 510
Los Angeles, California 91436-2964

Tel: (415) 788-3111
Fax: (415) 421-2017
Email: info@truckerhuss.com

www.truckerhuss.com