Retirement Plan Rule Throws Cold Water On ESG Factors

By **Robert Gower**

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On Oct. 30, the U.S. Department of Labor issued a final rule **amending the investment duties regulation** under Section 404(a) of the Employee Retirement Income Security Act. 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 subregulatory 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, or 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 long-standing 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 order to in order to satisfy that duty when selecting investments or investment courses of action. Specifically, the final rule provides the following.

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 nonpecuniary 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 nonpecuniary 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 nonpecuniary 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 nonpecuniary factors.

Qualified default investment alternatives, or QDIAs, which serve as default funds in participant-directed plans, may not consider nonpecuniary factors. Specifically, the final rule prohibits plan fiduciaries from using 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 nonpecuniary 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 nonpecuniary and, therefore, unacceptable as a component of a QDIA.

The DOL supports its strict position prohibiting consideration of nonpecuniary 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 nonpecuniary factors. By focusing on nonpecuniary factors, the DOL is able to more broadly address its concerns over subordinating financial interests for other motives, and 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 nonpecuniary 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 nonpecuniary factors as decisive.

With this in mind, plan fiduciaries who are unable to avoid applying nonpecuniary 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 nonpecuniary 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 nonpecuniary 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 nonpecuniary 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 its Nov. 13 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 nonpecuniary 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 nonpecuniary 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 presidential election will usher in a new Democratic administration — which may be more favorable toward striking a balance between achieving pecuniary motives and a participant's desire to achieve certain social and/or moral objectives with his or her retirement savings — the final rule is slated to become effective prior to the change of administration.

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.

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