DOL’s Final Rule on Investment Duties of ERISA Fiduciaries Becomes Effective

January 19, 2021

Overview

The final rule issued by the Department of Labor (“DOL”) prescribing the obligations of ERISA fiduciaries when selecting investments for ERISA plans became effective January 12, 2021 (the “Final Rule”). The Final Rule, which emphasizes the responsibility of fiduciaries to focus on economic factors when making investment recommendations, will have a significant impact on environmental, social and corporate governance (“ESG”) investing.

ESG investing has become a predominant theme in the financial media and investment management industry. Every day brings news articles related to ESG or new financial firms adopting ESG strategies. Family offices and registered investment advisors have created investment teams dedicated to ESG investment strategies in order to meet their clients’ interest in this fast-growing trend in investing. Even though ESG is becoming a staple in the investment industry, there are not yet uniform definitions of ESG, and therefore no clear or helpful lexicon for a regulatory standard.

The purpose of the Final Rule is to make clear that ERISA plan fiduciaries may not subordinate returns or increase risks to promote non-pecuniary objectives.

The duty of loyalty requires those serving as fiduciaries to act with a single-minded focus based on the interests of the beneficiaries. Further, the duty of prudence prevents a fiduciary from choosing an investment alternative that is financially less beneficial than reasonably available alternatives. Both of these fiduciary standards are the same no matter the investment vehicle or category.

The term "pecuniary factor" is a new term in the Final Rule. It is defined as a factor that has 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 401(a)(1) of ERISA.

The DOL believes that varied statements it has made over the years on the use of non-pecuniary or non-financial factors in sub-regulatory guidance may be partly to blame for the confusion with respect to the duty of loyalty and duty of prudence requirements. The DOL intends, through the Final Rule and amendments to investment duty regulations, to promulgate principles of fiduciary standards for selecting and monitoring investments and to set forth the scope of fiduciary duties surrounding non-pecuniary issues.

The primary goal of the Final Rule is to provide guidance on the scope of fiduciary duties surrounding non-pecuniary issues and to clear up the confusion with respect to the duty of loyalty and duty of prudence. It sets forth a regulatory structure to assist ERISA fiduciaries in navigating the ESG investment trends and to separate the legitimate use of risk-return factors from inappropriate investments that sacrifice investment returns, increase costs, or assume additional investment risk to promote non-pecuniary benefits or objectives.

The DOL noted that a survey conducted by the Callan Institute in 2019 found that about 19 percent of private sector pension plans consider ESG factors in investment decisions. Vanguard's 2018 administrative data shows that approximately nine percent of defined contribution plans offered one or more "socially responsible" domestic equity fund options.

This increased emphasis in the marketplace has captured the DOL's interest. The DOL's concern is that recent trends in ESG investing may lead ERISA plan fiduciaries to choose investments or investment courses of action to promote environmental, social, and other public policy goals unrelated to the interests of plan participants and beneficiaries in receiving financial benefits from the plan, and expose plan participants and beneficiaries to inappropriate investment risks or lower returns than reasonably available investment alternatives.

Regulatory Requirements

An ERISA fiduciary must recognize under the new rule that its investment decisions must be based only on pecuniary factors and that the fiduciary may not invest in ESG vehicles when an underlying investment strategy of the vehicle is to subordinate return or increase risk for the purpose of nonpecuniary objectives. In addition, the duty of prudence prevents a fiduciary from choosing an investment alternative that is financially less beneficial than an available alternative. However, the DOL does note it understands that at least some ESG factors, at times, may also be pecuniary factors (ex. an investment opportunity in a company that has potential costs and liabilities associated with cleaning

up environmental hazards such as toxic waste). The DOL deemed it appropriate for the regulation to include 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 Final Rule did not single out ESG investing or any other particular investment theory for particularized treatment.

The Final Rule provides that 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: why pecuniary factors were not sufficient to select the investment or investment course of action; how the investment compares to the alternative investments with regard to certain factors; and how the chosen non-pecuniary factor(s) are consistent with the interests of the participants and beneficiaries in their retirement income or financial benefits under the plan.

An investment course of action is defined to mean any series or program of investments or actions related to a fiduciary's performance of its investment duties, and includes the selection of an investment fund as a plan investment, or in the case of an individual account plan, a designated investment alternative under the plan.

The Final Rule contains standards applicable to participant-directed individual account plans. 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 must not sacrifice investment return or take on additional investment risk to promote non-pecuniary objectives or goals.

Fiduciaries who are considering investment alternatives for individual account plans should carefully review the prospectus or other investment disclosures for statements regarding ESG investment policies and investment approaches. Fiduciaries 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, goals, or principal investment strategies.

The special rule for qualified default investment alternatives ("QDIA's") is not focused on whether an investment alternative employs or applies any particular 'E', 'S', or 'G' factors in operation. The Final Rule focuses on whether the investment alternative includes, considers, or indicates the use of non-pecuniary factors in its investment objectives or goals or its principal investment strategies. The DOL acknowledges that the selection of ESG funds is not per se prudent or imprudent.

<u>Comments to the Rule</u>

Commenters asserted the proposed rule was unsupported by substantial evidence and was unwarranted by the facts, did not meet the minimum requirements of the Administrative Procedure Act, the Paperwork Reduction Act, or Executive Order and Office of Management and Budget guidelines on cost-benefit analysis, and argued that the rule would not withstand legal challenge in court. Others stated the rule did not demonstrate a compelling need for regulatory action nor

demonstrated any fiduciary action that was injurious to plans. Some additionally argued the DOL had failed to employ the least burdensome method to effect any necessary change or to present any empirical data or evidence of a problem that justified the regulation. Additionally, some commenters asserted that the DOL did not present a single example of any ERISA fiduciary allocating any investment on the basis of non-pecuniary criteria or any investigations or enforcement activity based on the concerns. Other commenters believed the current guidance was sufficient to enable the DOL to bring enforcement actions, and they further asserted the DOL regulation was not proposed pursuant to either an explicit statutory mandate or evidence of an actual documented problem.

The DOL was undeterred by such comments, but in many cases revised the proposed rule to address some of the concerns noted by commenters. For example, the Final Rule removes all ESG terminology from the proposed regulatory text. The DOL anticipates that when a fiduciary is faced with a purported ESG factor in an investment, the regulatory requirement is clearer and more consistent if it demands that fiduciaries focus on providing participants with the financial benefits promised under the plan and on whether a factor is pecuniary, rather than being required to navigate imprecise and ambiguous ESG terminology. The DOL also noted that under its authority to administer ERISA, it may promulgate rules that are preemptive in nature and is not required to wait for widespread harm to occur.

One commenter argued that the rule violates the Religious Freedom Restoration Act (“RFRA”). The commenter’s position is that the rule is a burden on religion and is contrary to RFRA. According to the commenter, by singling out ESG investment options as raising “heightened concerns under ERISA” whenever an option ambiguously might involve “one or more environmental, social, and corporate governance-oriented assessments or judgments,” despite the availability of numerous prudently managed and outperforming ESG investment options for ERISA pension plans, the proposal would have the practical effect of unnecessarily limiting access by people of faith to prudent pension investment options aligned with their religious beliefs.

The DOL stated it is committed to fulfilling its obligations under RFRA and respecting religious liberty. It is confident that the RFRA concerns raised can be reviewed and resolved as needed on an individual basis. However, the DOL did not provide any further guidance as to how those individual cases will be handled or reviewed. The DOL believes it did not need to conduct an applicable RFRA analysis in this particular rule, which according to the DOL, does not have religious concerns as a central focus. Time will tell if RFRA’s interaction with the rule reveals that a broader project is warranted, and whether the DOL will have to reconsider conducting an RFRA analysis.

Summary

The Final Rule was issued on October 30, 2020 and became effective on January 12, 2021. Investment advisors working directly with ERISA plans need to understand the implications of the Final Rule and should adopt policies and procedures to comply with the new investment duties regulation. Investment advisors should consider policies and procedures that adhere to a duty of prudence and a duty of loyalty; require the fiduciary to select investments solely on pecuniary factors; and when unable to determine which investment is in the best interests of the plan on the basis of pecuniary factors alone, document

the non-pecuniary factors supporting the investment decision.

[1] “Large Industry Members” are Industry Members other than Small Industry Members.

[2] “Small Industry Members” means an Industry Member that qualifies as a small broker-dealer as defined in SEC Rule 613.

[3] “Reportable Event” includes, but is not limited to, the original receipt or origination, modification, cancellation, routing, execution (in whole or in part) and allocation of an order, and receipt of a routed order.

Home