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DOL Releases Final ESG Rule

On October 30, 2020, the Department of Labor released its final rule on consideration of environmental, social, and corporate governance (ESG) factors in retirement plan investments under ERISA's general fiduciary rules.

Highlights

The final rule softens (somewhat) the original proposal, but retains most of its basic elements.

It eliminates the proposal's explicit focus on ESG factors; in the preamble, DOL states that "the Department is persuaded … that 'ESG' terminology, although used in common parlance when discussing investments and investment strategies, is not a clear or helpful lexicon for a regulatory standard."

Nevertheless, the rule retains the proposal's requirement that fiduciaries focus only on "pecuniary factors" in making investment decisions. These may include ESG factors if they are in fact pecuniary.

It retains (what some viewed as) a "stricter" application of the "tie-breaker" rule, requiring (among other things) documentation that there is in fact a "tie."

And the rule no longer prohibits inclusion of ESG funds in "qualified default investment alternatives" (QDIAs) (e.g., default target date funds), but does apply a higher standard for their inclusion.

The rule is effective for all investments made 60 days from publication in the Federal Register. There is a (limited) exception for "pre-existing" funds. There is no exception for "pre-existing" QDIAs; rather, plans have until April 30, 2022 to comply with the new QDIA requirement.

Summary of the new rule

The new rule changes the current rule under ERISA section 404(a) (ERISA's general fiduciary rule) in the following respects:

1. New prudence requirement to "compare alternatives." The current 404(a) regulation, which focuses exclusively on prudence, requires that a fiduciary must, with respect to an "investment or investment course of action," appropriately consider relevant facts/circumstances (including the investment's role in the portfolio) and "act accordingly."

In making its decision, the fiduciary must (as a matter of prudence) consider the following factors: diversification; liquidity and anticipated plan cash flow requirements; and projected return relative to plan funding objectives.

Appropriate consideration includes determining that the investment is "reasonably designed … to further the purposes of the plan," taking into account risk/opportunity for gain. Under the new rule, in this regard the investment must be "compared to the opportunity for gain (or other return) associated with reasonably available alternatives with similar risks." The latter language is the only change made by the new rule to current fiduciary prudence requirement.

2. A new "pecuniary factors only" requirement based on ERISA's fiduciary duty of loyalty. The new rule creates a requirement (under ERISA's fiduciary duty of loyalty requirement) that "an investment or investment course of action must be based only on pecuniary factors" except in certain tie-breaker situations.

"Pecuniary factor" is defined 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."

> DOL did not adopt two alternative "pecuniary factor" theories proposed by commentators. First, DOL rejected the theory that "ERISA permits or requires plan fiduciaries to premise investment decisions on the idea that, as investors, they own a share of the world economy, and, therefore, that their financial interests demand that they adapt their investment-related actions to promote a theoretical benefit to the world economy that might redound, outside the plan, to the benefit of the participants in the plan." Second, with respect to multiemployer plans, DOL reiterated its position that "increased [multiemployer] plan contributions and similar factors are not economic factors, but … they are the type of non-economic factor that may be considered where a fiduciary is permitted to make an investment decision on the basis of a non-pecuniary factor."

3. Limited tie-breaker exception. The new rule retains a *limited* "tie-breaker" exception. Where the fiduciary can't distinguish between investments based on pecuniary factors alone, it may consider non-pecuniary factors provided it documents: (i) why pecuniary factors weren't sufficient to distinguish between investment alternatives; (ii) how the selected investment compares to the alternative investments with regard to the factors noted in 1. above (diversification, liquidity, etc.); and (iii) how the non-pecuniary factor(s) is consistent with participant interests in plan retirement income/financial benefits.

4. Rules for investment alternatives in participant-directed DC plans. A DC plan that allows participants to choose investments from a "broad range of investment alternatives" may include as a designated investment alternative "an investment fund, product, or model portfolio" that "promotes, seeks, or supports one or more non-pecuniary goals" so long as the fiduciary satisfies ERISA's (general) fiduciary rules and the (specific) loyalty requirements described in 2. and 3. above. Quoting from the preamble:

> [F]iduciaries are indeed permitted to add, to platforms or menus, designated investment alternatives that may produce collateral benefits or otherwise are viewed by some as socially desirable. But, importantly, these alternatives may be added *only if they can be justified solely on the basis of pecuniary factors…*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 or goals or its principal investment strategies.

This language is likely to cause some fund operators to focus intensely on prospectus wording in an effort to satisfy this "pecuniary interest" standard.

5. Special rule for QDIAs. An investment may not be part of a plan's QDIA "if its investment objectives or goals or its principal investment strategies include, consider, or indicate the use of one or more non-pecuniary factors." This language is a little hard to pin down. The preamble gives the following example:

> [I]f the prospectus or similar disclosure states that the fund (or any component) is constructed using an ESG or sustainability rating system or index, and that ratings system or index evaluates one or more factors that are not financially material to investments (i.e., evaluates non-pecuniary factors), then [this rule] would prohibit such fund from being used as a default investment alternative.

It goes on to clarify that:

> Screening strategies, regardless of whether they are characterized or described as "positive screening" or "negative screening," may implicate [this rule] if the screening involves non-pecuniary factors that effectively results in the exclusion of certain sectors or categories of investments…This is because such an exclusion in an investment alternative's objectives or principal strategies raises questions as to the extent to which the QDIA's manager may be foregoing financial returns in pursuit of non-financial objectives.

Inclusion of an ESG fund in a QDIA will be a priority for some sponsors and providers. Figuring out how to come within this new standard may prove to be a challenge. In this regard, the ERISA fiduciary burden will be on the plan fiduciary.

Effective date

As noted at the top, the rule is effective for all investments made 60 days from publication in the Federal Register.

There is thus no obligation to immediately divest, e.g., current ESG funds, *but*…"after the effective date, all decisions regarding such investments,…including decisions that are part of a fiduciary's ongoing monitoring requirements, must comply with the final rule."

With respect to "monitoring" after the effective date of, e.g., funds included in a fund menu before the effective date, a footnote explains:

> [The Supreme Court's decision in] Tibble v. Edison Int'l (2015) confirmed that ERISA fiduciaries have a continuing duty—separate and apart from the duty to exercise prudence in selecting investments at the outset—to monitor, and remove imprudent, trust investments. How that monitoring obligation would be applied in the context of the final rule's application to individual investments would depend on the facts and circumstances. When and what kind of review would depend on the facts and circumstances…The 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.

Applying this rule will present a challenge for plan fiduciaries.

Generally, no enforcement for pre-effective date decisions

DOL also stated 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…by a plan fiduciary prior to the effective date…to the extent that any such enforcement action would necessarily rely on citation to this final rule." It's not clear how much protection from litigation by third parties this language provides.

While the final rule is in some respects an improvement over the proposal, many sponsors and providers will remain dissatisfied.

There were many objections in Congress to the proposal, and it will be interesting to see how Congress reacts to this final rule. With a change in Administrations as a result of the election, we may see further rulemaking on this topic.

We will continue to follow this issue.

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