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ESG Investing by ERISA Plan Fiduciaries: The DOL Final Regulations

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On October 30, 2020, the U.S. Department of Labor ("DOL") released final regulations addressing the standards that plan fiduciaries must meet when selecting investments for their ERISA-covered plan, including so-called ESG (environmental, social, governance) investments. The final regulations were issued at warp-speed after the DOL issued the proposed regulations on June 23, 2020. At its core, the final regulations require plan fiduciaries to focus exclusively on pecuniary factors (e.g., factors that materially impact risk and return) when selecting investments for their plan. The final regulations are the culmination of a long trail of regulatory and sub-regulatory guidance issued by the DOL. This column summarizes the DOL's prior guidance, describes the final regulations, and provides advice to plan investment committees who may want to add an ESG fund to their plan's portfolio.

Prior Guidance

Title I of the Employee Retirement Income Security Act of 1974 ("ERISA") sets forth standards of fiduciary conduct that govern the operation of 401(k) plans and other ERISA-covered plans. In part, plan

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fiduciaries are required to act prudently[1] and diversify plan investments so as to minimize the risk of large losses, except when it is clearly prudent not to do so.[2] Plan fiduciaries are also required to act solely in the interest of the plan's participants and beneficiaries, and for the exclusive purpose of providing benefits to participants and beneficiaries.[3]

Courts have described ERISA's fiduciary duties as the "highest known to law."[4] They have interpreted ERISA to require fiduciaries to act with "complete and undivided loyalty to the beneficiaries."[5] When making a decision, plan fiduciaries must act "with an eye single to the interests of the participants and beneficiaries."[6] Further, the U.S. Supreme Court has held that such interests are "financial" interests.[7]

Over the last few decades, the DOL has addressed the interplay of these principles with a plan fiduciary's decision to select an investment fund that provides collateral benefits. Such benefits include environmental, social, and corporate governance investing. A fund which provides any of these benefits is now commonly referred to as an "ESG fund."

The DOL's initial guidance on ESG funds was set forth in Interpretive Bulletin 94-1.[8] In Interpretive Bulletin 94-1, the DOL stated that ERISA does not prevent plan fiduciaries from investing plan assets in an ESG fund if the fund has an expected rate of return equal to (or greater than) rates of return of alternative investments with similar risk characteristics. This concept is often referred to as the "tie-breaker" concept, meaning that if all things are equal from a financial perspective, the ESG benefits that a fund provides may be the deciding factor in the fiduciary's investment decision.

In 2008, the DOL replaced Interpretive Bulletin 94-1 with Interpretive Bulletin 2008-01.[9] Interpretive Bulletin 2008-01 retained the "tie-breaker" concept but also emphasized that the primary focus of plan fiduciaries must be on return and risk and that fiduciaries are prohibited from subordinating the interests of participants in their retirement income to unrelated objectives. The DOL also cautioned that fiduciaries violate ERISA if they accept reduced potential returns or increased risks to secure policy goals, such as social or environmental policy goals.

In 2015, the DOL replaced Interpretive Bulletin 2008-01 with Interpretive Bulletin 2015-01.[10] Interpretive Bulletin 2015-01 reiterated much of Interpretive Bulletin 2008-01, but also indicated that ESG factors should not be ignored if it is appropriate to consider them from a financial perspective.

In 2018, the DOL issued Field Assistance Bulletin 2018-01 ("FAB").[11] The FAB indicated that, in issuing Interpretive Bulletin 2015-01, the DOL was recognizing that there could be instances in which ESG factors are material financial factors. In such situations, the ESG factors should be considered by the plan fiduciary along with other relevant financial factors to evaluate the investment. In such instances the ESG factors are not "tie-breakers," but financial factors affecting the economic merits of the investment. The DOL cautioned, however, that the weight given to

ESG factors should be appropriate relative to other financial factors and that fiduciaries must not too readily treat ESG factors as economically relevant to a particular investment choice. While the FAB cautioned plan fiduciaries against assuming ESG factors are economically relevant, it stated that, a properly diversified investment lineup could include ESG investments.

Due to an increase in ESG investing, the DOL released proposed regulations on July 23, 2020, to clarify a plan fiduciary's investment duties under ERISA, particularly with respect to ESG investing.[12] The proposed regulations amend existing regulatory guidance on a ERISA's fiduciary's investment duties. The proposed regulations state, in no uncertain terms, that plan fiduciaries must focus exclusively on pecuniary factors when selecting investments for their retirement plan and are not permitted to sacrifice investment return or take on additional investment risk to promote non-financial benefits or goals. In addition, the proposed regulations:

(i) Require fiduciaries to consider other available investments to meet their prudence and loyalty duties under ERISA;

(ii) Acknowledged that ESG factors can be pecuniary factors, but only if they present economic risks or opportunities that a qualified investment professional would treat as material economic considerations under generally accepted investment theories;

(iii) Set forth investment analysis and documentation requirements in the "rare" circumstances when fiduciaries are choosing among truly "indistinguishable" investments (tie breaker rule);

(iv) Add a new provision on selecting designated investment alternatives for a defined contribution individual account plan; and

(v) Prohibit ESG funds from being a plan's qualified default investment alternative ("QDIA").

The Final Regulations

Following a comment period, during which the DOL reportedly received thousands of mostly negative comments, the DOL released final regulations on October 30, 2020. Generally, the final regulations rollback some of the rigid requirements set forth in the proposed regulations, but continue to strike the same cautionary tone on ESG investing, including retaining the requirement that only pecuniary factors may be considered when selecting investments. A description of the final regulations is set forth below.

To begin, the final regulations reiterate ERISA's requirements that a fiduciary must discharge that person's duties solely in the interests of the participants and beneficiaries, for the exclusive purpose of providing benefits to participants and their beneficiaries and defraying reasonable expenses of administering the plan, and 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 (the "prudent person requirement").[13] Plan committees should be well-acquainted with these requirements.

Next, the final regulations state that when a plan fiduciary discharges its investment duties, it will satisfy the prudent person requirement if he or she has given "appropriate consideration" to those facts and circumstances that, given the scope of such fiduciary's investment duties, the fiduciary knows or should know are relevant to the particular investment involved, including the role the investment plays in that portion of the plan's investment portfolio, and has acted accordingly.[14]

Under the final regulations, the term "appropriate consideration" includes, but is not necessarily limited to, a determination by the fiduciary that the particular investment is reasonably designed, as part of the portfolio (or, where applicable, that portion of the plan portfolio with respect to which the fiduciary has investment duties), to further the purposes of the plan, taking into consideration the risk of loss and the opportunity for gain (or other return) associated with the investment compared to the opportunity for gain (or other return) associated with reasonably available alternatives with similar risks.[15] "Appropriate consideration" also includes consideration of the following factors:

(i) The composition of the plan portfolio with regard to diversification;

(ii) The liquidity and current return of the portfolio relative to the anticipated cash flow requirements of the plan; and

(iii) The projected return of the portfolio relative to the funding objectives of the plan.[16]

The final regulations then state that a fiduciary's evaluation of an investment must be based solely on "pecuniary" factors, other than where non-pecuniary factors "break the tie" as described below.[17] Further, a fiduciary may not subordinate the interests of participants in their retirement income to other objectives, and may not sacrifice investment return or take on additional risk to promote non-pecuniary benefits or goals.[18] The final regulations define the phrase "pecuniary factor" to mean any factor that a prudent fiduciary 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.[19] The weight given to any pecuniary factor by a fiduciary should appropriately reflect a prudent assessment of its impact on risk-return.[20]

When choosing between or among investments that a fiduciary is unable to distinguish on the basis of pecuniary factors alone (i.e., when there is a tie), the final regulations provide that the fiduciary may use non-pecuniary factors as the deciding factor (i.e., to break the tie), provided that the fiduciary documents:

(i) Why pecuniary factors were not able to serve as a sufficient basis to select the investment;

(ii) How the selected investment compares to the alternative investments with regard to the pecuniary factors; and

(iii) How the chosen non-pecuniary factor or factors are consistent with the interests of participants in their retirement income under the plan.[21]

The final regulations next address the manner in which plan fiduciaries should select investments for participant-directed individual account plans, such as 401(k) plans.[22] In this regard, the final regulations note that plan fiduciaries must act in a manner consistent with their duties of prudence and loyalty, including giving "adequate consideration" to any investment, as described above.[23] Further, plan fiduciaries must select investments for their plans based solely on pecuniary factors (except in the very rare instance that a pecuniary factor may serve as a tie-breaker).[24] The final regulations specifically state that if a participant-directed individual account plan provides a broad range of investment alternatives, a fiduciary is not prohibited from selecting an investment fund (or product or model portfolio) that promotes, seeks, or supports one or more non-pecuniary goals, provided that:

(i) The aforementioned duties of prudence and loyalty are satisfied;

(ii) Consideration is only given to pecuniary factors when selecting the fund; and

(iii) The investment fund (or product or model portfolio) does not serve as the plan's QDIA.[25]

Finally, the regulations state that they shall be effective 60 days after the publication of the final rule, and shall apply in its entirety to all investments made and investment courses of action taken after such date.[26] Further, plans shall have until April 30, 2022 to make any changes to their QDIA, where necessary to comply with the requirements of final regulations.[27]

What Plan Committees Need to Do

The final regulations provide a pathway for adding an ESG fund to a plan's investment lineup, although caution must be exercised. Plan fiduciaries who fear running afoul of the final regulations will, obviously, want to avoid ESG investing altogether.

Committees who wish to consider ESG investing should initially consider the reasons for adding an ESG fund to the plan's portfolio. A good reason (i.e., a pecuniary reason), is that adding an ESG fund can provide diversity to an investment lineup. In that regard, the committee may wish to consider ESG funds along with other specialized funds (e.g., heath care, technology, real estate), to ascertain that an ESG fund is the best fit for the plan. An ESG fund can provide diversity in many forms, including capitalization, style, investment diversification, risk and return. An ESG fund should not be added based on the committee's desire to do "social good" or to achieve some other non-pecuniary benefit.

Once the committee has settled on an ESG fund, the committee should direct its investment manager to conduct a search and present several candidates from which the committee may choose. Under the final regulations, the committee must give "adequate consideration" to the fund's selection. In other words, they must give appropriate consideration to those facts which it knows, or should know, are relevant to the investment decision. Normally, a plan fiduciary (who often is a company officer with no specific expertise in investments) does not know what facts are relevant, other than having a rudimentary understanding that risk, return and fees are relevant. The plan's investment advisor will need to help guide the committee.

When evaluating the candidates, the investment advisor and the committee need to focus solely on pecuniary factors, i.e., those factors which the fiduciary prudently determines to materially impact risk and return. The candidates' risk, return and fees should be measured against broad, widely-used benchmarks (not ESG-exclusive benchmarks). Other quantitative and qualitative measures should also be considered to the extent they can be considered pecuniary factors, such as the size of the fund (based on assets under management), the tenure of the fund's investment manager, the methodology of the investment manager, and the investment advisor's rating of the fund. The ESG character of a fund could also be a pecuniary factor. However, not all pecuniary factors are treated equal – plan fiduciaries must weigh each pecuniary factor based on a prudent assessment of its impact on risk and return.

When comparing fund candidates, it is not impermissible to note their ESG characteristics, their ESG rating based on the investment advisor's rating system, or their performance versus ESG-only benchmarks, but these should not serve as the basis for selecting a fund. Plan fiduciaries must understand that they are prohibited from subordinating the interests of participants to unrelated objectives and sacrificing investment

return or taking on additional investment risk to promote nonpecuniary goals.

Under the final regulations, the committee must also consider during the selection process how the ESG investment is designed to further the purposes of the plan. The "plan purpose" should be set forth in the plan's Investment Policy Statement. For example, if the purpose of a 401(k) plan is to "provide participants with an opportunity to save for retirement and to invest their retirement savings based on their individual risk/return preferences" the committee should ascertain that the new investment furthers this purpose. In addition, the committee should ascertain that the new investment satisfies the purpose of diversifying the plan's portfolio, does not give rise to liquidity concerns (mutual funds typically do not present liquidity concerns, but other types of investments might), and that the new investment's rate or return is consistent with the plan's funding objectives. This last point would only be relevant in the context of a defined benefit pension plan.

When tackling ESG issues, plan committees must consult with their ERISA counsel who will ensure that the foregoing requirements are met and documented properly in the meeting minutes. DOL investigations of plan fiduciaries have dramatically increased since around the time the proposed regulations were issued. These investigations cast a wide net and cover not only ESG investing but all other aspects of fiduciary compliance. Accordingly, it is important, now more than ever, to have ERISA counsel present at committee meetings.

Conclusion

The final regulations provide a pathway for plan committees to add an ESG fund to their plan's investment lineup, but they must proceed with caution. When selecting an ESG fund, plan committees must focus exclusively on pecuniary factors. They are also prohibited from subordinating the interests of participants to unrelated objectives and sacrificing investment return or taking on additional investment risk to promote nonpecuniary goals. With the help of ERISA counsel, a committee can add an ESG fund to their plan in a manner that satisfies their fiduciary responsibilities.

Notes

1. ERISA § 404(a)(1)(B).
2. ERISA § 404(a)(1)(C).
3. ERISA § 404(a)(1)(A)(i).
4. *See, e.g., Tibble v. Edison Int'l*, 843 F.3d 1187, 1197 (9th Cir. 2016).

5. *Donovan v. Mazzola*, 716 F.2d 1226, 1238 (9th Cir. 1983) (*quoting Freund v. Marshall & Ilsley Bank*, 485 F. Supp. 629, 639 (W.D. Wis. 1979)).

6. *Donovan v. Bierwirth*, 680 F.2d 263,271 (2d. Cir. 1982).

7. *Fifth Third Bancorp v. Dudenhoeffer*, 573 U.S. 409, 421 (2014) (the "benefits" to be pursued by ERISA fiduciaries as their "exclusive purpose" does not include "nonpecuniary benefits") (emphasis in original).

8. 59 FR 32606 (June 23, 1994) (appeared in Code of Federal Regulations as 29 CFR 2509.94-1).

9. 73 FR 61734 (Oct. 17, 2008).

10. 80 FR 65135 (Oct. 26, 2015).

11. Field Assistance Bulletin No. 2018-01 (Apr. 23, 2018).

12. 85 FR 39113 (June 30, 2020).

13. DOL Reg. § 2550.404a-1(a).

14. DOL Reg. § 2550.404a-1(b)(1).

15. DOL Reg. § 2550.404a-1(b)(2)(i).

16. DOL Reg. § 2550.404a-1(b)(2)(ii).

17. DOL Reg. § 2550.404a-1(c)(1).

18. *Id.*

19. DOL Reg. § 2550.404a-1(f)(3).

20. DOL Reg. § 2550.404a-1(c)(1).

21. DOL Reg. § 2550.404a-1(c)(2).

22. DOL Reg. § 2550.404a-1(d).

23. DOL Reg. § 2550.404a-1(d)(1).

24. *Id.*

25. DOL Reg. § 2550.404a-1(d)(2).

26. DOL Reg. § 2550.404a-1(g)(1).

27. DOL Reg. § 2550.404a-1(g)(2).

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