VOL. 49, NO. 3 WINTER 2023

Employee Relations
LAW JOURNAL

Employee Benefits

ESG Investing by ERISA Plan Fiduciaries: The Saga Continues

By Mark E. Bokert and Alan Hahn

There has been a long, confusing trail of regulatory and sub-regulatory guidance issued by the U.S. Department of Labor (DOL) dealing with the standards that plan fiduciaries must meet when selecting socially-conscientious investments for their retirement plan (i.e., so-called ESG investments). Most recently, the Biden administration issued final regulations to address the "chilling effect" that prior guidance had on a fiduciary's ability to consider social factors. Although these new regulations appear to make it easier for plan fiduciaries to invest plan assets in ESG funds, risks still lurk. Plan fiduciaries should work with their ERISA counsel to understand the totality of the guidance and the risks before investing plan assets in an ESG investment.

Prior Guidance

Over the last few decades, the DOL has addressed the interplay of ERISA's fiduciary duties[1] with a plan fiduciary's decision to invest plan assets in an ESG fund. The issue has become a political "hot potato" with the media portraying guidance issued during Republican

Mark E. Bokert is a partner and co-chairs the Benefits + Compensation Practice Group of Davis+Gilbert LLP. His practice encompasses nearly all aspects of executive compensation and employee benefits, including matters related to equity plans, deferred compensation plans, phantom equity plans, qualified retirement plans, and welfare plans. Mr. Bokert may be contacted at mbokert@dglaw.com. Alan Hahn is a partner and co-chairs the firm's Benefits + Compensation Practice Group. His practice is devoted to advising clients of all sizes, including in the design and implementation of a wide variety of creative, unique, and tax-effective employee benefit plans and programs. Mr. Hahn may be contacted at ahahn@dglaw.com.

administrations as restricting ESG investments and guidance issued during Democratic administrations as making it easier to make ESG investments.

The DOL's initial guidance on ESG funds was set forth in Interpretive Bulletin 94-1.[2] 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 collateral benefits that an ESG 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.[3] 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.[4] 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). 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.

The DOL under the Trump administration released final regulations on October 30, 2020, which generally struck a cautious tone on ESG investing (the Trump-era Regulations).[5] The Trump-era Regulations stated that a fiduciary's evaluation of an investment must be based solely on "pecuniary" factors,[6] other than where non-pecuniary factors "break the tie." 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.[7]

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 Trump-era Regulations provided 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.[8]

With respect to participant-directed individual account plans that provide a broad range of investment alternatives, the Trump-era Regulations provided that 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 duties of prudence and loyalty are satisfied;

(ii) Consideration is 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.[9]

The DOL under the Biden administration then issued its own set of final regulations to unwind the Trump-era Regulations.[10]

The Final Regulations

The final regulations issued by the DOL under the Biden administration provide general guidance on the fiduciary duties of prudence and loyalty. Regarding the duty of prudence, the final regulations provide that a fiduciary must give "adequate consideration" to those facts and circumstances that "the fiduciary knows or should know are relevant to the particular investment or investment course of action." [11] This includes an evaluation of whether "the particular investment or investment course of action is reasonably designed, as part of a portfolio . . . to further the purposes of the plan."[12] Plan fiduciaries must also take "into consideration the risk of loss and the opportunity for gain" compared to other reasonable alternatives.[13]

The final regulations emphasize that a fiduciary's decision with respect to an investment "must be based on factors that the fiduciary reasonably determines are relevant to a risk and return analysis."[14] Whether any particular factor is relevant to a risk/return analysis will depend on facts and circumstances, but the final regulations provide that risk/return factors "may include the economic effects of climate change and other environmental, social, or governance factors."[15]

With regard to the duty of loyalty, the final regulations also provide that a "fiduciary may not subordinate the interests of the participants and beneficiaries in their retirement income or financial benefits under the plan to other objectives, and may not sacrifice investment return or take on additional investment risk to promote benefits or goals unrelated to interests of the participants and beneficiaries in their retirement income or financial benefits under the plan."[16] In other words, a plan fiduciary must not "accept expected reduced returns or greater risk to secure additional benefits."[17]

The final regulations state that if a fiduciary prudently determines that competing investments "equally serve the financial interests of the plan over the appropriate time horizon, the fiduciary is not prohibited from selecting the investment based on collateral benefits"[18] such as ESG factors. The final regulations also provide that a fiduciary of a participant-directed individual account plan, such as a 401k plan, "does not violate the duty of loyalty . . . solely because the fiduciary takes into account participants' preferences in a manner consistent" with the duty of prudence.[19]

The final regulations differ from the Trump-era final regulations in several respects. First, the final regulations eliminate the prohibition against adding or retaining an investment fund as a qualified default investment alternative if the fund reflects non-pecuniary objectives in its investment strategy. As indicated above, the final regulations also clarify the tiebreaker rule, stating that the tiebreaker rule can be used in circumstances where competing investment funds "equally serve the financial interests of the plan over the appropriate time horizon."[20] The final regulations also eliminate the requirements that a fiduciary be unable to distinguish between investment alternatives on the basis of "pecuniary factors alone" and meet certain documentation requirements in order to implement the tiebreaker rule.[21]

Potential Risks

Despite the apparent relaxing of standards for investing in ESG funds, plan fiduciaries still face certain risks, including audit and litigation risk. Around the time that the Trump-era Regulations were being made final, the DOL initiated audits targeting fiduciaries of plans that offered an ESG fund. The audits went far beyond ESG investing. During the audits, the DOL investigated the entirety of the plan's fiduciary process, including how investment committee members were selected, how the committee conducted its business, what information the committee reviewed, how the investment advisor and ERISA attorney were selected, how the ESG and other funds were selected and monitored, and whether the investment committee acted independently or merely rubber-stamped their experts' advice. In conducting these audits, the plan fiduciaries were required to turn over all meeting minutes, performance reports and other pertinent information. While a DOL audit targeting ESG investing is not likely to occur under the Biden administration, it is possible that future administrations will use the power of the DOL to once again make life difficult for plan fiduciaries that allow ESG investments.

In addition, plan fiduciaries may be faced with litigation over their decision to add an ESG fund to their plan. For example, on June 2, 2023, a pilot from American Airlines sued the airline and other defendants in the U.S. District Court for the Northern District of Texas, Fort Worth Division,[22] alleging that plan fiduciaries breached their ERISA fiduciary duties by investing millions of dollars in and among investment managers and investment funds that pursue "environmental, social and governance ('ESG') strategies, proxy voting, and shareholder activism – activities which fail to satisfy these fiduciaries' statutory duties to maximize financial benefits in the sole interest of the Plan participants."[23] The plaintiff further alleged that many of the ESG funds that defendants included in the American Airlines' Plan "are more expensive for Plan participants to own compared with similar non-ESG investment funds, underperform financially compared with similar non-ESG investment funds," and engage in shareholder activism to achieve ESG policy agendas rather than maximize the risk-adjusted financial returns for Plan participants.[24]

Advice For Plan Committees

Plan fiduciaries who are significantly risk-adverse may wish to avoid ESG investing altogether. But for those plan fiduciaries who are less wary, the final regulations provide a pathway for adding an ESG fund to a plan's investment lineup, although caution must still be exercised.

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, although the committee may consider the desire of Plan participants to add an ESG fund to the plan.

Once the committee determines to move forward, the committee should direct its investment advisor 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 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 ESG fund candidates, it is not impermissible to note each fund's 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.

A committee should also consider 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.

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 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. Section 404(a)(1) 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 fiduciaries are required to act prudently and diversify plan investments so as to minimize the risk of large losses, except when it is clearly prudent not to do so. 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.

2. 59 FR 32606 (June 23, 1994) (appeared in Code of Federal Regulations as 29 CFR 2509.94-1).

3. 73 FR 61734 (Oct. 17, 2008).

4. 80 FR 65135 (Oct. 26, 2015).

5. 85 FR 72846 (Nov. 13, 2020).

6. 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. The weight given to any pecuniary factor by a fiduciary should appropriately reflect a prudent assessment of its impact on risk-return. Id. at 72884.

7. Id.

8. Id.

9. Id.

10. 29 CFR § 2550.404a-1.

11. Id. § 2550.404a-1(b)(1)(i).

12. Id. § 2550.404a-1(b)(2)(i).

13. Id.
14. Id. § 2550.404a-1(b)(4).
15. Id.
16. Id. § 2550.404a-1(c)(1).
17. Id. § 2550.404a-1(c)(2).
18. Id. § 2550.404a-1(c)(2).
19. Id. § 2550.404a-1(c)(3).
20. 29 CFR § 2550.404a-1(c)(2).
21. 85 Fed. Reg. at 72884.
22. Case 4:23-cv-00552-O (the Complaint).
23. Complaint, page 2.
24. Complaint, page 4, paragraph 4.