June 26, 2020

DOL Proposes Rule to Severely Restrict ESG Considerations in Selecting ERISA Plan Investments

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On June 23, 2020, the U.S. Department of Labor (DOL) proposed amendments to the investment duties regulations under ERISA that would make it clear that retirement plan fiduciaries must not consider non-financial factors in making investment decisions for ERISA-covered retirement plans (including 401(k) plans). This guidance is of particular importance in light of recent trends involving the flows into so-called environmental, social and governance (ESG) funds and the integration of ESG factors into investment decisions by retirement plans. If finalized as proposed, the rule would both expand on the DOL's long-standing position that decisions concerning the selection and monitoring of investments must focus solely on economic considerations and further add to the current administration's series of pronouncements that has generally discouraged allocating assets to ESG funds and ESG integration by ERISA plans.

Existing DOL Guidance on ESG Investments and Integration

The DOL has been asked periodically over the last three decades[1] to address the fiduciary concerns triggered when plan investments are selected based on the non-pecuniary benefits they may promote, such as those relating to some ESG considerations. This guidance has been consistent in its core message that non-pecuniary considerations cannot override pecuniary considerations, but the "gloss" placed on the ability to consider non-pecuniary considerations has shifted over time. In FAB 2018-01, the DOL said that:

- ERISA fiduciaries may not sacrifice investment returns or assume greater investment risks to promote collateral social policy goals, but ESG factors may serve as tie-breakers when evaluating investment opportunities, and
- when ESG issues present risks and opportunities that investment professionals would treat as economic considerations, a prudent fiduciary should consider the ESG economic considerations together with other relevant economic factors.

However, FAB 2018-01 also cautioned that fiduciaries "must not too readily" treat ESG factors as economically relevant to particular investment choices and that they must properly incorporate economically relevant ESG factors to reflect their level of risk and return. (For additional background discussion of FAB 2018-01, see our Alert here.)

Overview of the Proposed Regulation

New Investment Duties for Plan Fiduciaries

The proposal builds upon established principles of prudent investment evaluation by explicitly requiring fiduciaries to evaluate investments based solely on pecuniary factors that have a material effect on the return and risk of an investment according to appropriate investment horizons and the plan's articulated funding and investment objectives (insofar as such objectives are consistent with ERISA). The rule creates an explicit obligation for a fiduciary to conclude that its decision is consistent with this principle and that it has not subordinated the interests of the participants and beneficiaries to its own interests or any non-pecuniary concerns and must otherwise comply with its duty of loyalty.

[1] In 2008, the DOL replaced its first comprehensive statement on ESG issues in Interpretive Bulletin 94-1 with Interpretive Bulletin 2008-01 (IB 2008-01). In 2015, the Department replaced IB 2008-01 with Interpretive Bulletin 2015-01 (IB 2015-01), which is codified at 29 CFR 2509.2015-01. In 2018, the Department issued Field Assistance Bulletin 2018-01 (FAB 2018-01) to further clarify IB 2015-01.

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In light of its investment duties, a fiduciary must give ***appropriate consideration*** (emphasis added) to those facts and circumstances that it knows or should know are relevant to the particular investment or investment course of action involved, including the role the investment plays in that portion of the plan's portfolio with respect to which the fiduciary has discretion.

The current regulation sets forth a non-exclusive list of factors that ought to be evaluated in order to demonstrate the exercise of appropriate consideration, including:

- the composition of the portfolio for purposes of diversification;
- the liquidity and current return of the portfolio relative to the anticipated cash flow requirements of the plan; and
- the projected return of the portfolio relative to the funding objectives of the plan.

The proposal adds a requirement that, with respect to each of the previously mentioned factors, the fiduciary has to compare the selected investment to available alternative investments.

Evaluation of Pecuniary and Non-Pecuniary Factors

The proposal includes a new section that provides a framework for considering pecuniary and non-pecuniary factors in evaluating and selecting investments. A "pecuniary factor" is defined in the proposal 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 402(a)(1) of ERISA. According to the DOL, plan fiduciaries are not permitted to sacrifice investment return or take on additional investment risk to promote non-pecuniary benefits or any other non-pecuniary goals.

ESG or other similarly considerations are pecuniary factors ***only if*** (emphasis added) they present economic risks or opportunities that qualified investment professionals would treat as material economic considerations under generally accepted investment theories. The proposal further provides that:

- the weight given to those factors should appropriately reflect a prudent assessment of their impact on risk and return; and
- fiduciaries are required to examine the level of diversification, degree of liquidity, and the potential risk-return of an ESG investment in comparison with other available alternative investments that would play a similar role in their plans' portfolios.

In a case where two investments are determined to be economically indistinguishable even after conducting the evaluation just described, and one of the investments is selected on a non-pecuniary basis—a case the DOL says it considers to occur rarely, if at all—the proposal requires a fiduciary to document specifically why the investments were determined to be indistinguishable. Furthermore, the fiduciary must document why the selected investment was chosen based on the purposes of the plan, the diversification of investments, and the interests of plan participants and beneficiaries in receiving benefits from the plan.

Special Considerations for Asset Managers

The proposal severely restricts the ability of plan fiduciaries to take into account collateral considerations in evaluating and selecting investments outside of the tie-breaker scenario. In some cases, this will limit the ability of a plan fiduciary to consider ESG factors (or selected ESG factors). Asset managers seeking to offer their funds to plan fiduciaries should consider whether their ESG-related marketing or disclosure may make it harder for plans to select their products. This is true for any fund that features a discussion of ESG considerations as part of the investment process, even if the fund is

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not a so-called "ESG fund." Managers may wish to revise their marketing and disclosure materials to more clearly and directly describe the material pecuniary benefits that ESG factors offer to investors in a fund, or they may wish to more clearly indicate how ESG factors are factored into the fund's investment decisions. In any event, managers should consider the accuracy and sufficiency of their ESG-related disclosures in light of the SEC's increasing focus on this area during examinations of registered investment advisers.

Because the proposal only would apply to a subset of the investor community, inbound asset flows to ESG, sustainable, responsible and impact investment strategies are expected to continue to increase, albeit perhaps at a somewhat slower pace. In addition, many large asset owners will continue to require managers across strategies to adhere to both affirmative and negative covenants relating to ESG matters.

The proposal also will not dampen the call by managers for relevant, comparable, decision-useful ESG-related information from issuers. In particular, pressure will continue to build for issuers to report information in line with the Sustainable Accounting Standards Board standards and the recommendations of the Task Force on Climate-related Financial Disclosures.

Special Considerations for Plan Fiduciaries

Although the proposal's restrictions on being able to consider collateral considerations may not amount to a major substantive change for plan investment decisions, it will be important for plan fiduciaries to make clear that they only considered pecuniary factors in evaluating a fund, or in selecting from among multiple funds. Furthermore, plan fiduciaries should be especially careful in describing and documenting their investment evaluation process with respect to ESG-focused investments. Unless the ESG considerations are believed to have a material positive 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, they should not factor into the investment decision.

Documentation is one of the areas where the proposal may cause the biggest shift for plan fiduciaries, as the proposal reverses prior guidance suggesting no extra documentation was required for considering ESG investments. Under the proposal, extra documentation is required in the tie-breaker scenario for pension plan fiduciaries that select investments on the basis of a non-pecuniary factor (ESG or otherwise).

Special Considerations for Individual Account Plan Sponsors

The proposal also sets forth requirements for the prudent consideration of designated investment alternatives for participant-directed individual account plans that include one or more ESG investment mandates (or include ESG in their names). The proposal provides that, for investment platforms that allow plan participants and beneficiaries to choose from a broad range of investment alternatives, the addition of one or more prudently selected, well-managed, and properly diversified investment alternatives that include one or more ESG mandates would not violate ERISA's fiduciary standards, but only if:

- the fiduciary uses only objective risk-return criteria, such as benchmarks, expense ratios, fund size, long-term investment returns, volatility measures, investment manager investment philosophy and experience, and mix of asset types (e.g., equity, fixed income, money market funds, diversification of investment alternatives, which might include target date funds, value and growth styles, indexed and actively managed funds, balanced and equity segment funds, non-U.S. equity and fixed income funds), in selecting and monitoring all investment alternatives for the plan, including any environmental, social, corporate governance, or similarly oriented investment alternatives;

- the fiduciary documents its selection and monitoring of the investment in accordance with the criteria above; and

- the ESG alternative is not added as, and is not a component of, a qualified default investment alternative (QDIA).

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While the proposal permits a plan fiduciary to include a prudently selected, ESG-themed investment alternative on a 401(k) plan investment lineup if the fiduciary uses (and documents) objective risk-return criteria, the fiduciary is not allowed to accept reduced returns or greater risks in order to secure non-pecuniary benefits. Moreover, the DOL sees the extra documentation requirement for the selection and monitoring of investment alternatives that include one or more ESG (or similarly oriented) mandates, or that include these parameters in the fund name, as an extension of the prudent fiduciary practice of documenting and maintaining records of investment choices. Finally, the DOL takes the view that investment funds whose objectives include non-pecuniary goals such as ESG goals—even if selected by fiduciaries only on the basis of objective risk-return criteria—should not be the default investment option in an individual account plan.

If the rule is finalized as proposed, fiduciaries for individual account plans should consider the role of funds that integrate ESG factors in the plan's investment menu, with a special focus on QDIAs, and should diligently document these considerations.

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