

November 2, 2020

DOL Finalizes Rule on ESG Considerations for ERISA Plan Investments

On October 30, 2020, the U.S. Department of Labor (DOL) finalized its amendments to the investment duties regulation under ERISA (Final Regulation), which sets out the standards for plan fiduciaries selecting investments and provides guideposts for the consideration of non-financial objectives such as environmental, social and governance (ESG) aims. The overarching principle of the Final Regulation, which is now the DOL's definitive guidance on the topic, is that when making decisions on investments and investment courses of action, an ERISA plan fiduciary must focus solely on the plan's financial risks and returns and the interests of plan participants and beneficiaries. In response to the vociferous opposition the proposed rule generated from various stakeholders including asset managers, plan sponsors and individual plan participants, the DOL eliminated all ESG-specific references in the Final Regulation and clarified that there is no per se prohibition on selecting or considering investment strategies that incorporate ESG so long as it is based solely on material economic considerations.

Attorneys

[William D. Jewett](#)
[Joshua A. Lichtenstein](#)
[Peter N. Rosenberg](#)
[Sabrina C. Glaser](#)
[Melissa C. Bender](#)
[Isabel K.R. Dische](#)
[Michael R. Littenberg](#)
[Emily J. Oldshue](#)

Overview of the Final Regulation

Expansion of the Fiduciary Duty of Prudence

The Final Regulation expands on the duty of prudence, which was addressed in the existing investment duties rule, by requiring a fiduciary to consider whether a “particular investment or investment course of action 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 or investment course of action **compared to the opportunity for gain (or other return) associated with reasonably available alternatives with similar risks**” (emphasis added to highlight new language). The expanded language makes it clear that a fiduciary is required to compare any investment option (whether or not it incorporates ESG factors) against other similar investments. This is unlikely to require substantial changes to the process followed by most ERISA fiduciaries.

The Fiduciary Duty of Loyalty: Evaluating Investments Based on Pecuniary Factors

Like the proposed rulemaking (For additional background discussion of the DOL's proposal, see our Alert [here](#)), the Final Regulation modifies the existing rule by incorporating the duty of loyalty in addition to the existing references to prudence. The core of the Final Regulation provides that an ERISA fiduciary's “evaluation of an investment or investment course of action must be based **only** (emphasis added) on pecuniary factors”. Fiduciaries are also required to weight each pecuniary factor based on a prudent assessment of its impact on risk and return. A “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. The DOL generally left the definition of a pecuniary factor intact from the proposal except it now includes a requirement that the fiduciary make a prudent judgment.

The Final Regulation links the pecuniary factors requirement to the duty of loyalty by stating that ERISA fiduciaries may not subordinate the interests of participants to unrelated objectives and they are barred from sacrificing investment returns or taking on additional investment risk to promote non-pecuniary benefits or goals. The Final Regulation omits the proposal's language about what could make ESG considerations and similarly-oriented factors pecuniary (i.e., that they present economic risks or opportunities that qualified investment professionals would treat as material economic

considerations under generally accepted investment theories). The Final Regulation also eliminates the proposal's requirement that a fiduciary examine the level of diversification, the degree of liquidity, and the potential risk and return in comparison with other available alternative investments, when evaluating ESG factors as pecuniary factors. The DOL decided to remove ESG terminology from the Final Regulation on the grounds that such terminology can be imprecise and ambiguous. Moreover, the DOL was concerned about the risk of constraining the criteria that a fiduciary would consider in making a prudent judgment. As a result, the Final Regulation instead mandates fiduciaries to focus on whether any particular factor is pecuniary.

Tiebreaker Scenario

If an ERISA fiduciary is unable to distinguish on the basis of pecuniary factors alone when choosing between or among investment alternatives – a so-called “tiebreaker” scenario – the fiduciary is permitted to use a non-pecuniary factor as the deciding factor if the fiduciary documents the following:

- why pecuniary factors were not sufficient to select the investment or investment course of action;
- how the selected investment compares to the alternative investments with regard to composition, liquidity, and returns of the plan's portfolio; and
- how the chosen non-pecuniary factor or factors are consistent with the interests of participants and beneficiaries in their retirement income or financial benefits under the plan.

Investment Alternatives for Individual Account Plans

The Final Regulation also makes it clear that the same prudence and loyalty duties that apply generally to evaluating investments under ERISA are applicable to a fiduciary's evaluation and selection of designated 401(k) investment alternatives from which participants and beneficiaries select where to invest their retirement assets. In other words, when constructing or modifying an investment menu for an individual account plan, the fiduciary must evaluate the designated investment alternatives on the menu based solely on pecuniary factors. If the prudence and loyalty duties described above are met, fiduciaries may choose an investment fund, product or model portfolio as a designated investment alternative on the plan menu even if it incidentally supports one or more non-pecuniary goals. However, the Final Regulation preserves the restriction contained in the proposal on selecting an investment fund, product or model portfolio that includes the use of one or more non-pecuniary factors, as (or as a component of) a qualified default investment alternative (QDIA), while rephrasing the rule to focus specifically on the product's investment objectives or goals and principal investment strategies.

Effective Dates

Recognizing that some plans may have to make adjustments to their investment policies and practices, the DOL has provided a sixty-day grace period following publication of the Final Regulation in the Federal Register and has stipulated that the rule shall apply prospectively in its entirety to investments made after that effective date. Moreover, the DOL explained in the preamble that fiduciaries will not be required to divest or cease any existing investment or investment course of action, or designated investment alternative, even if originally selected in a manner that would now be prohibited by the Final Regulation. Separately, the prohibition on selecting an investment fund, product or portfolio that includes the use of non-pecuniary factors as an individual account plan's QDIA will not take effect until April 30, 2022.

Will the Proxy Voting Proposal Be Next on the DOL's Radar?

Like the Final Regulation, the DOL's proxy voting proposal, issued in September 2020, is premised on the idea that financial factors impacting plans and their participants and beneficiaries should be the only considerations driving

fiduciary decision-making. In this case, the DOL has proposed additional amendments to the investment duties regulation to address how ERISA fiduciaries should exercise shareholder rights, including proxy voting. If finalized as proposed, the proxy voting rulemaking could well stem the reliance of plan fiduciaries and delegated investment managers on proxy advisory firms by (i) requiring the fiduciary or investment manager to refrain from voting when the economic analysis does not justify doing so and (ii) imposing additional monitoring duties on fiduciaries such as ensuring the proxy advisory firm justify its rationale for voting decisions or recommendations and demonstrate that they align with the plan's economic interests. It would also impose significant additional documentation obligations on plan fiduciaries by requiring them to maintain records on all proxy voting activities and other exercises of shareholder rights, including records that demonstrate the basis for the decision to make or abstain from particular proxy votes and exercises of shareholder rights.