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Business Alert

# DOL Final Rule Continues to Discourage ESG Investments by ERISA Plans

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The U.S. Department of Labor (the "DOL") recently issued a final regulation (the "Final Rule") under the Employee Retirement Income Security Act of 1974 ("ERISA") amending the pre-existing "investment duties" regulation under ERISA.[1] In essence, the Final Rule continues to discourage plan fiduciaries from considering investments that promote non-financial objectives, such as environmental, social, corporate governance or other similarly oriented ("ESG") objectives.

Generally, the Final Rule is consistent with the DOL's proposed rule on ESG investments (the "Proposed Rule") and comports with the DOL's long-standing position on ESG issues (see our prior alert here). Although the DOL made a number of changes in the Final Rule that are intended to clarify, and arguably simplify, the investment decision-making process for ERISA fiduciaries considering ESG factors, the Final Rule has not fundamentally changed the DOL's stance against ESG-oriented investments by ERISA plans.

The following describes the key provisions of the Final Rule and, where relevant, notes the changes made from the Proposed Rule:

- The Final Rule eliminates all references to ESG concepts from its regulatory text, based on the DOL's recognition that the term "ESG" lacks uniform usage and precise definition.Instead, the Final Rule requires fiduciaries to evaluate investments based solely on "pecuniary factors."
- Although the term "pecuniary factor" as used in the Final Rule largely retains the definition from the Proposed Rule, the Final Rule adopts a more flexible approach allowing fiduciaries to determine what constitutes a pecuniary factor.Specifically, the Final Rule defines "pecuniary factor" as a factor that *a fiduciary prudently determines is expected* to have a material effect on the risk and/or return of an investment.
- The Final Rule retains the DOL's belief that "tie-breaker" scenarios permitting investment decisions based on non-pecuniary factors are extremely rare.Although the Final Rule clarifies when a tie-breaker situation may occur (i.e., when fiduciaries are unable to distinguish investment alternatives solely based on pecuniary factors), as a practical matter, ERISA fiduciaries should continue to refrain from making investment decisions based on non-pecuniary factors.
- The Final Rule retains the documentation requirement, which was first introduced in the Proposed Rule, for any tie-breaker investment decisions based on non-pecuniary factors.Specifically, fiduciaries must document: (1) why pecuniary factors were not sufficient to select the investment; (2) how the selected investment compares to the alternative investments with regard to composition, liquidity and returns; and (3) how the non-pecuniary factors considered in making the investment decision are consistent with the interests of the participants in their retirement income or financial benefits under the plan.This documentation requirement has the practical effect of further discouraging ERISA fiduciaries from making investment decisions based on non-pecuniary factors.
- The Final Rule removes the multi-pronged duty of loyalty standards that were included in the Proposed Rule, and instead, provides that fiduciaries may not subordinate the interests of participants in their retirement income or financial benefits under the plan to other objectives.In this regard, the Final Rule prohibits fiduciaries from sacrificing investment returns or assuming additional investment risks in pursuit of non-pecuniary objectives.
- Fiduciaries of participant-directed individual account plans (such as a "401(k)" plan) will continue to be generally prohibited from considering non-pecuniary factors in the selection (or retention) of designated investment alternatives available to plan participants. With respect to qualified default investment alternatives ("QDIAs"), the Final Rule retains the per se prohibition on selecting an investment alternative that uses non-pecuniary factors in its investment objectives or principal investment strategies.

In essence, the Final Rule codifies the DOL's long-held view that ERISA fiduciaries should not consider non-pecuniary factors in making investment decisions for ERISA plans.  In that respect, we do not expect the current approach to ESG-oriented investments to change fundamentally for many ERISA fiduciaries.  However, as we have noted previously in connection with the Proposed Rule, ERISA fiduciaries should consider whether their current investment policies and procedures comport with the fiduciary standards and affirmative obligations set forth in the Final Rule, particularly with respect to ESG-oriented investments.  In addition, investment managers offering their funds to plan fiduciaries or otherwise managing ERISA separate accounts or "plan assets" funds should consider the implications of the Final Rule for any non-pecuniary factors influencing the funds' investment decisions (including how non-pecuniary factors are described in the funds' marketing and disclosure materials).

The Final Rule will become effective on January 12, 2021 and, with limited exception, will apply prospectively to investment decisions made after the effective date.  Fiduciaries of individual account plans are required to modify or divest QDIAs that do not comply with the Final Rule by April 30, 2022.

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[1] ERISA requires that a fiduciary act "solely in the interest" of the plan participants and beneficiaries and "for the exclusive purpose" of providing benefits and paying reasonable administrative expenses, using the so-called "prudent expert" standard set forth in ERISA.  The investment duties regulation, as amended by the Final Rule, prescribes how a plan fiduciary may discharge such duties of prudence and loyalty when evaluating an investment.

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