Executive Compensation, Employee Benefits and ERISA Alert

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DOL Issues Final Regulation Regarding ESG Investment Considerations

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On October 30, 2020, the U.S. Department of Labor (DOL) issued a final rule regarding the use by Employee Retirement Income Security Act of 1974, as amended (ERISA), fiduciaries of nonpecuniary, such as environmental, social and corporate governance (ESG), considerations when investing the assets of employee benefit plans subject to ERISA. In the News Release announcing the final rule, DOL Secretary Scalia stated that "This rule will ensure that retirement plan fiduciaries are focused on the financial interests of plan participants and beneficiaries, rather than on other, non-pecuniary goals or policy objectives." The rule was initially proposed by the DOL on June 23, 2020, and the DOL made several changes to the proposed rule in response to over 1,100 unique comment letters that it received.

In the preamble to the final rule, the DOL noted its concern that "the growing emphasis on ESG investing may prompt ERISA plan fiduciaries to make investment decisions for purposes distinct from providing benefits to participants and beneficiaries and defraying reasonable expenses of administering the plan" (i.e., the "exclusive purpose" rule under Section 404(a) of ERISA). In the preamble to the proposed rule, the DOL noted that "[c]ourts have interpreted the exclusive purpose rule of ERISA section 404(a)(1)(A) to require fiduciaries to act with 'complete and undivided loyalty to the beneficiaries,' observing that their decisions must 'be made with an eye single to the interests of the participants and beneficiaries.' The U.S. Supreme Court as recently as 2014 unanimously held in the context of ERISA retirement plans that such interests must be understood to refer to 'financial' rather than 'nonpecuniary' benefits, and federal appellate courts have described ERISA's fiduciary duties as 'the highest known to the law.'"

The DOL specifically noted its concern that some investment products may be marketed to ERISA fiduciaries on the basis of purported benefits and goals unrelated to financial performance. For example, the DOL noted its understanding that, in the case of some ESG investment funds being offered to ERISA defined contribution plans, fund managers are representing that the fund is appropriate for ERISA plan investment platforms, while acknowledging in disclosure materials that the fund may perform differently or forgo certain opportunities, or accept different investment risks, in order to pursue the ESG objectives. The DOL noted that the final rule is designed to

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make clear that ERISA fiduciaries may not invest in ESG vehicles when they understand an underlying investment strategy of the vehicle is to subordinate return or increase risk for the purpose of nonpecuniary objectives. The duty of loyalty, a bedrock principle of ERISA, requires those serving as fiduciaries to act with a single-minded focus on the interests of beneficiaries. In addition, the DOL noted that the duty of prudence prevents a fiduciary from choosing an investment alternative that is financially less beneficial than an available alternative.

In the preamble to the proposed rule, the DOL stated that the regulation is merely a codification of the DOL's "longstanding and consistent position, reiterated in multiple forms of guidance and based on the explicit language of ERISA itself" that in making investment decisions, plan fiduciaries must be focused solely on the plan's financial risks and returns, and the interests of plan participants and beneficiaries. In short, "**ERISA fiduciaries must never sacrifice investment returns, take on additional investment risk, or pay higher fees to promote non-pecuniary benefits or goals."**

With this background in mind, the final rule:

- Sets forth in regulatory context the DOL's prior guidance that (i) an ERISA fiduciary's duties of prudence and loyalty are satisfied where the fiduciary has "selected investments and/or investment courses of **action based solely on their pecuniary factors and not on the basis of any non-pecuniary factor**" and (ii) ERISA fiduciaries are prohibited from subordinating the interests of participants and beneficiaries to the fiduciary's or another's interests. While the proposed rule explicitly referenced ESG factors, the final rule limits its discussion to the more general concept of pecuniary factors, which are defined as "a factor that a fiduciary prudently determines is expected to have 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(b)(1) of ERISA."
- Amends the existing DOL regulation regarding ERISA fiduciary duties to provide that fiduciaries must compare investments (or investment courses of action) to other available investments (or investment courses of action) **based solely on economic factors** (i.e., the risk of loss and the opportunity for gain (or other return) with an investment compared to the opportunity for gain (or other return) associated with reasonable available alternatives with similar risks, in each case as part of the plan's portfolio). The basic concept is that fiduciaries are reminded that they should not let nonpecuniary considerations distract them from obtaining the best economic results for the plan.
- In the preamble, provides that nonpecuniary considerations may be taken into consideration if they "present economic risks or opportunities that qualified investment professionals would treat as material economic considerations under generally accepted investment theories," e.g., a company's improper disposal of hazardous waste or dysfunctional corporate governance.
- Sets forth in regulatory context the DOL's prior guidance that, ESG factors can be used as a "tie breaker" between financially equivalent investments. In the preamble to the final rule, however, the DOL "cautions fiduciaries against too hastily concluding that ESG-themed funds may be selected based on pecuniary factors or are not distinguishable based on pecuniary factors." In this regard, the final rule requires that, where investment alternatives are economically indistinguishable and

where the investment selected is based on nonpecuniary ESG factors, fiduciaries must document why the investments are determined to be indistinguishable from a pecuniary standpoint, how the selected investment compares to alternative investments with respect to the plan's composition, liquidity and returns and how the nonpecuniary factor or factors is consistent with the interests of participants and beneficiaries in the benefits under the plan. The reason for this documentation requirement is, in part, due to the DOL's belief that in the real world, ties do not really exist and thus requiring such documentation will better focus a plan fiduciary on their responsibilities.

- Provides that a fiduciary's addition of prudently selected ESG oriented investments as an investment option under a defined contribution plan would not violate ERISA where:
  - The fiduciary acts solely in the interests of plan participants and beneficiaries and considers only pecuniary factors in making such determinations.
  - The ESG oriented fund is not added as, or as a component of, a qualified default investment alternative (QDIA) if its investment objectives or goals or its principal investment strategies include, consider or indicate the use of one or more nonpecuniary factors. In the preamble to the final rule, the DOL addressed a comment that the proposed rule seemed to preclude any QDIA which was constructed using any ESG factor, even if the factor was pecuniary in nature, and the DOL stated that was not its intent.
- Raises questions regarding funds which exclude "sin" stocks such as alcohol and tobacco, which are often included in retirement plans of religious organizations. One comment to the proposed rule argued that the rule's application under these circumstances would violate the Religious Freedom Restoration Act (RFRA). The DOL addressed this concern by noting that "the RFRA concerns raised by the commenter can be reviewed and resolved as needed on an individual basis." It is not entirely clear how this would be administered.

The final rule will generally be effective 60 days following its publication in the Federal Register and will apply to all investments made and investment courses of action taken after that date. In the preamble to the final rule, the DOL states that fiduciaries will not be required to dispose of any existing investments or cease any existing investment course of action that would violate the final rule provided that they were otherwise permissible when made or undertaken. With respect to any QDIA that would violate the final rule, changes are not required to be made until April 30, 2022.

Although the final rule, and existing ERISA law and guidance currently in effect regarding ESG, is not specifically applicable to outside investment managers who do not otherwise manage "plan assets" (e.g., investment managers of collective investments funds which qualify as "venture capital operating companies" or managers of funds in which benefit plan investors do not own 25 percent or more of any class of equity security of such fund), the ERISA limitations on ESG investment could have (and already likely do have) a chilling effect on raising ERISA-based capital for any investment fund or product that has a purpose to focus on and/or promote ESG factors. Asset managers marketing themselves as ESG investors must consider that ERISA-based capital may be difficult to raise for such products, especially to the extent that investment decisions regarding ESG investments for the fund may factor in nonfinancial considerations.

To the extent the marking materials related to a product or a fund acknowledge that investment returns may be compromised and/or risk increased due to ESG factors, an ERISA fiduciary would need to disregard the DOL's view on these types of investments in deciding to make such an investment. To the extent that ERISA-based capital is desirable, an investment manager should be careful to highlight, if in fact true, that all investment decisions are made to bolster investment return and/or deleverage risk. While ESG factors may be considered, they will only be considered to the extent that such factors present economic risks or opportunities that qualified investment professionals would treat as material economic considerations under generally accepted investment theories. We do not recommend that any investment manager represent and/or advertise that any of their investment products are appropriate for ERISA-based capital as that decision should be left to the ERISA plan's investment committee and/or manager deciding to make the investment.

There have been some indications that presumptive President-elect Biden might seek to reverse certain recently enacted federal regulations, including the final rule. Because the final rule will be published in the federal register within 60 legislative days of the Presidential inauguration, under the Congressional Review Act, Congress could reverse the rule. However, it is unclear whether Congress would take such action, especially in light of the make-up of the new Senate. Accordingly, any reversal of the final rule, absent congressional action, would require formal rulemaking process by the Department of Labor.

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