DOL ISSUES FINAL "ESG" RULE; FOCUSES ON "PECUNIARY" FACTORS

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On 30 October 2020, the Department of Labor (DOL) released its final rule “Financial Factors in Selecting Plan Investments” (Final Rule).[1] Although the proposed rule aimed to regulate environmental, social, and corporate governance (ESG) investing by employee benefit plans subject to the Employee Retirement Income Security Act (ERISA),[2] in the Final Rule, DOL rejected the ESG nomenclature as too unclear.[3] The text of the Final Rule removes all ESG terminology, focusing instead on whether a factor is “pecuniary.”[4] While this change may remove some perceived stigma for plan fiduciaries in considering ESG factors when selecting plan investments, the difference in terminology has not changed the underlying requirement that the plan fiduciary focus only on factors that make a financial impact.

Under the Final Rule, 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, and may not subordinate the interests of the participants and beneficiaries in their retirement income or financial benefits under the plan to other objectives. Instead, a fiduciary's evaluation of an investment or investment course of action must be based only on pecuniary factors. The weight given to any pecuniary factor by a fiduciary should appropriately reflect a prudent assessment of its impact on risk-return.[5]

The Final Rule defines a “pecuniary” factor to mean “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 the funding policy established pursuant to section 402(b)(1) of ERISA.”[6]

One exception where plan fiduciary can use non-pecuniary factors remains the “tie-breaking” scenario. In the Final Rule, DOL simplified the tie-breaker test to focus on situations in which the fiduciary is unable to distinguish investment alternatives on the basis of pecuniary factors alone. In this case, the fiduciary may use non-pecuniary factors as the deciding factor.[7] Addressing a concern expressed by investment managers, DOL confirmed in the Final Rule that investments are not required to be identical in each and every respect before the tie-breaker provisions become available. However, to consider non-pecuniary factors as tie-breakers, a plan fiduciary must document:

1. why pecuniary factors were not sufficient to select the investment;
2. how the selected investment compares to the alternative investments; and
3. 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.

DOL indicated that it requires this documentation to "safeguard against the risk that fiduciaries will improperly find economic equivalence and make decisions based on non-pecuniary factors without a proper analysis and evaluation."[8] Based on its statements in the preamble to the Final Rule, DOL remains skeptical about whether investment options can ever be true "ties" based on the consideration of pecuniary factors alone.[9]

CHANGES FROM PROPOSED RULE

The Final Rule contains some changes from the proposed rule. The most relevant differences between the proposed rule and the Final Rule, and their key impacts are set out in our chart (https://files.klgates.com/webfiles/DOL_Regulation_Comparison.pdf.)

PRACTICAL IMPLICATIONS

Product Manufacturers. While some investment products, such as mutual funds and exchange-traded funds, are not subject to ERISA, all product manufacturers should consider ERISA principles, including the Final Rule, if the investment product will be marketed to ERISA investors. If a mutual fund or exchange-traded fund integrates ESG factors into the investment process for non-financial reasons or discloses that investment performance may be adversely impacted because of the portfolio manager's consideration of ESG factors, an ERISA fiduciary, such as a consultant or a plan's retirement plan investment committee may not be able to recommend or offer the investment product to defined contribution plan participants or cause a defined benefit plan to invest in the investment product. Accordingly, product manufacturers should (a) review how ESG factors are integrated into the investment process and whether such factors are pecuniary factors, (b) review disclosures, (c) consider whether they have the necessary tools and expertise to meet the ERISA standards, (d) prepare to receive enhanced scrutiny regarding these matters from consultants and plan sponsors, and (e) consider whether any sub-advisers have been properly reviewed from an ERISA perspective.

Consultants. Many plan sponsors rely on advice from consultants regarding investment matters, such as investment manager selection and monitoring. Plan sponsors are increasingly delegating discretionary authority to consultants to hire and terminate investment managers.[10] In both models, the consultant should be familiar with ERISA principles and the Final Rule when advising clients on, or selecting, investment managers and investment products that integrate ESG factors into the investment process. Consultants should (a) review their process for evaluating investment managers that consider ESG factors (e.g., should changes be made to due diligence questionnaires), (b) consider whether they have the necessary tools and expertise to evaluate investment managers, (c) review investment manager disclosures to ensure consistency with ERISA, and (d) prepare to receive enhanced scrutiny regarding these matters from plan sponsors in requests for proposals and requests for information.

Plan Sponsors. Plan sponsors or retirement plan investment committees appointed by plan sponsors, may have fiduciary responsibility over plan investments. If the plan sponsor works with a consultant, the plan sponsor will have co-fiduciary responsibility over the plan's investments or fiduciary responsibility to oversee the consultant. In each case, the plan sponsor should consider ERISA principles and the Final Rule before an ESG investment option is included in a defined contribution plan investment menu (especially as a default investment option) or causing a defined benefit plan to hire an investment manager who integrates ESG factors into the investment process. Plan sponsors should (a) evaluate whether their consultants have sufficient expertise regarding ESG matters, (b) consider whether changes should be made to RFPs and RFIs used in connection with hiring

consultants, and (c) consider whether they have the necessary tools and expertise to evaluate ESG matters in addition to more traditional investment matters.

EFFECTIVE DATE AND ENFORCEMENT

The Final Rule will be effective 60 days following the date of publication in the Federal Register and shall apply prospectively to investment decisions made after such date, which include decisions to continue to offer existing investment options to defined contribution plan participants. DOL acknowledged that some plans may need to make adjustments to their investment policies and practices as a result of the Final Rule. Although plan fiduciaries will need to be in compliance with most aspects of the Final Rule by the effective date, plans will have an extended compliance period, until 30 April 2022, to make any necessary changes to qualified default investment alternatives that currently may consider non-pecuniary ESG factors.

However, until the Final Rule becomes effective, DOL's current standards on ESG investing as set out in its prior sub-regulatory guidance (discussed in our previous client alert) remain applicable. DOL notes that, while the Final Rule will apply prospectively, nothing in the Final Rule forecloses DOL "from taking enforcement action based on prior conduct that violated ERISA's provisions, including the statutory duties of prudence and loyalty, based on the statutory and regulatory standards in effect at the time of the violation."[11]

CONCLUSION

Even though ESG terminology has been removed from the Final Rule, ESG investing, and the determination of whether an ESG factor is a pecuniary factor, remains a key focus both in the Final Rule and in the ERISA fiduciary world in general. Plan fiduciaries should examine their current investing practices to ensure they are compliant with the Final Rule, and product manufacturers and marketers seeking ERISA investment should keep the requirements of the Final Rule top of mind.

The authors and other members of K&L Gates' ERISA practice have extensive experience advising ERISA fiduciaries and financial institutions, and are prepared to guide interested parties through the challenges presented by the Final Rule.

If you have questions or want to discuss the issues described in this Alert, please contact any of the individuals listed below or any member of our global asset management and investment funds practice.

FOOTNOTES

[1] The Final Rule is scheduled to be published in the Federal Register on 13 November 2020.

[2] Please see our Client Alert discussing the proposed rule.

(https://files.klgates.com/webfiles/DOL_Regulation_Comparison.pdf)

[3] "The Department is persuaded by its review of the public comments that 'ESG' terminology, although used in common parlance when discussing investments and investment strategies, is not a clear or helpful lexicon for a regulatory standard." Preamble to the Final Rule, page 44.

4 The Preamble to the Final Rule still contains extensive discussion of ESG investing and reflects DOL's 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." Preamble to the Final Rule, page 9.

[5] 29 CFR § 2550.404a–1(c)(1).

[6] 29 CFR § 2550.404a–1(f)(3).

[7] 29 CFR § 2550.404a–1(c)(2).

[8] Preamble to the Final Rule, page 62.

[9] 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, thereby triggering the tie-breaking provision of paragraph (c)(2) of the final rule." Preamble to the Final Rule, page 50.

[10] Discretionary services are often referred to as "3(38) services" or "OCIO services." "3(38)" refers to section 3(38) of ERISA, which defines "investment manager." "OCIO" refers to "outsourced chief investment officer."

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