INSIGHTS

By Compensation & Benefits Policy Research

ESG Retirement Plan Funds Will Be Challenged Under DOL Final Rule

Overview

- Over the last several years, especially given recent events, there has been a trend among investors towards funds and investment strategies focused on environmental, social or governance (ESG) criteria. Younger and socially conscious investors, in particular, are looking to choose investments based on the sustainability and social impact.
- Though plan sponsors have not yet widely added such funds, most have been evaluating and considering the addition in the near future. The current ESG climate and pressure from plan participants has only accelerated the process. Employers have also realized that the addition of these funds could lead to employees having a more favorable view of their employer and help promote a desired culture.
- In light of this upward trend, the Department of Labor (DOL) issued a proposed rule on June 23, 2020 which had the potential to create a significant roadblock for ERISA retirement plans wishing to add fund choices based on ESG principles.
- After receiving thousands of comments and submissions to the proposed rule (where a good portion were in the opposition), a final rule titled "Financial Factors in Selecting Plan Investments" was published on October 30, 2020. The DOL took the comments into consideration and though there were significant modifications, the final rule may still result in a chilling effect on the offering of ESG-themed fund options overall.
- The final rule is effective on January 12, 2021 (60 days after being published in the federal register). Impacted plans will have until April 30, 2022 to make any changes necessary to comply with the final rule.

Background

- To protect plan participants, Title I of ERISA imposes stringent investment duties on fiduciaries tasked with selecting investment options for covered plans such as 401(k)s, qualified pensions, etc. These duties include a requirement that fiduciaries act solely in the interest of the plan's participants and beneficiaries, and for the exclusive purpose of providing benefits to those individuals and defraying reasonable expenses of administering the plan.
- When making decisions on investments and investment courses of action, plan fiduciaries must focus solely on the plan's financial returns. It has often been understood that this standard requires giving priority to a fund that is financially more beneficial rather than an available alternative, regardless of the investment category.
- Trying to determine how ESG funds fit into this evaluation process by the plan sponsor has been complicated. Over the years there has been varying guidance, often dependent upon whether the then-current administration was Republican or Democrat. Generally, most interpreted the rule to say that ESG funds were not necessarily incompatible with ERISA fiduciary obligations and that such ESG factors could, at the very least, be used as a tie-breaker between two comparably performing funds with comparable risk.

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Final Rule

- This rule comes from a concern on the part of the DOL that the increasing attraction and trend toward ESG factors may be resulting in plan fiduciaries putting less emphasis on fund performance, fund risk, and fund expense when choosing funds and instead focusing on elements of the fund on the basis of benefits and goals unrelated to financial performance.
- The DOL wants to make it clear that ERISA covered retirement plans cannot be used to further social goals or policy objectives and that it is unacceptable for a fiduciary to potentially sacrifice return and increase risk to promote what may be seen as a non-economic (political or social) end. The goal is to redirect fiduciaries back to utilizing financial factors as the ultimate priority when selecting a fund and eliminate any confusion they might have from previous guidance as to their responsibility when it comes to considering non-pecuniary (including ESG) factors.
- The new rule elaborates the core principles of the investment duties regulation under ERISA and essentially requires plan sponsors to choose funds based primarily upon pecuniary considerations. A pecuniary consideration is one that 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.
- In the proposed rule, ESG-themed funds were not technically forbidden, but the bar was significantly raised. Mainly due to the great deal of opposition toward the proposed rule, the final rule makes some key changes, lowering that bar somewhat from what was originally proposed. The DOL ultimately removed all ESG-specific terminology from the text of the final rule. Instead, they chose to use the terms pecuniary factors and non-pecuniary factors. However, the preamble to the final rule does specifically discuss ESG factors and how the final rule would apply to them.
- The components of the final rule are as follows:
  - The duty of prudence and loyalty requirements under ERISA prohibit fiduciaries from subordinating the interests of plan participants and beneficiaries for the purpose of non-financial objectives. It will be unlawful for a fiduciary to sacrifice return or accept additional risk to promote a public policy, political, or any other non-financial goal.
  - Comparison of any investment or investment course of action to other investments or investment courses of action must be done primarily on the basis of pecuniary factors which should "appropriately reflect a prudent assessment of its impact on risk and return." The final rule replaced the listed requirements of the level of diversification, degree of liquidity, and potential risk and return with this general language. However, risk and return should still be evaluated based upon objective criteria that includes benchmarks, expense ratios, fund size, long-term investment returns, volatility measures, investment manager tenure, and mix of asset types.
  - ESG factors can be a valid financial consideration, but only if they present economic risks or opportunities under generally accepted investment theories. Where ESG factors are determined to be a valid financial consideration, they cannot be disproportionality weighted. The preamble provided a few examples of where an ESG factor could be considered pecuniary, including a company's improper disposal of hazardous waste and poor corporate governance.
  - The proposed rule included language requiring plans to consider other available investments to meet their prudence and loyalty duties under ERISA in advancing the purposes of the plan. In response to comments, the final rule clarifies that, in comparing investment alternatives, plans need not "scour the market." Instead, they need only compare "reasonably available" alternatives.
  - The proposed rule explained that non-financial elements would still be allowed as a secondary factor in the fund decision process (i.e., a tie breaker), but only in the rare circumstance where the fiduciary has determined funds are economically indistinguishable. Pursuant to much disagreement from the public on this "economically indistinguishable" requirement, the DOL simplified the tie breaker test. In a situation where a fiduciary is unable to distinguish investment alternatives on the basis of pecuniary

factors alone, the investments do not have to be identical in each and every way before the tie-breaker provision would be available. Rather a fiduciary must consider "reasonably available alternatives with similar risks." The increased documentation requirement remains and specific guidelines are provided as a means to stem abuse. Fiduciaries will be required to document any occurrences where such a tie is purported to exist, including why the investment was chosen based on the purposes of the plan, diversification of investments, and the interests of the plan participants and beneficiaries.

- Under the proposed rule, an ESG related fund was prohibited as a qualified default investment alternative (QDIA). The final rule eased up on this blanket prohibition and states that a fund is only prohibited as a QDIA if its investment objectives, goals, or principal investment strategies include, consider, or indicate the use of one or more non-pecuniary factors.

Considerations for Plan Sponsors

- Plan sponsors will want to evaluate steps that will need to be taken to comply with the final rule. For example, carefully review any changes with your investment advisers or consultants to ensure compliance and proper direction going forward, update investment policy statements, educate the investment committee on the changes, and evaluate ESG funds currently offered for compliance.
- Plan sponsors may also want to consider an effective way to communicate to and/or educate plan participants on the complexity of offering such ESG funds under these guidelines. This type of transparency will be vital, especially to those plan participants looking for change.
- Plan sponsors should note the increased level of scrutiny by the DOL when it comes to ESG funds and ERISA covered retirement plans. Caution and extremely careful consideration is advised. Continued diligence is essential, especially in light of the rise of participant scrutiny and litigation.
- Proper documentation of the fund selection to demonstrate proper analysis and evaluation has always been important, but even more critical should the decision come to include non-pecuniary factors.

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