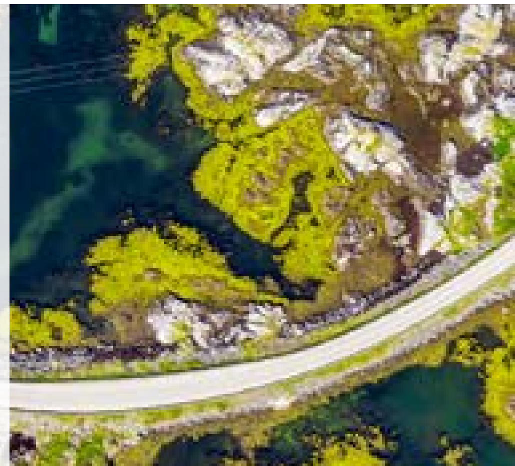
DOL Paves the Way for ERISA Plan ESG Investments in Final "Pecuniary Factor" Rule

By Bradford Campbell



New rule takes effect on January 12, 2021

The U.S. Department of Labor (DOL) shook up the retirement plan world in June when it issued a new proposed regulation that caused a lot of confusion about the role of environmental, social and governance (ESG) investments in Employee Retirement Income Security Act (ERISA) plans. Attempting to codify the gist of more than 25 years of guidance documents in a new regulation should have been relatively simple – after all, DOL guidance since 1994 consistently held that ESG and similar investments are prudent and appropriate for ERISA plans when used properly.

Unfortunately, the proposed regulation instead muddied the waters. While it clearly permitted ESG investments in ERISA plans, it also seemed to require additional documentation, and limited how ESG investments could be used. As a result, in what may be a record for the number of comments on an ERISA fiduciary regulation, DOL received more than 8,000 comments,[1] almost all of them critical of the proposal. These comments generally called for a final rule focusing on prudent investment decisions across the board, treating ESG investments the same as other investments and removing ESG-specific standards.

The good news is that it worked. On November 13, 2020, DOL published the final rule regarding "Financial Factors in Selecting Plan Investments" (the Pecuniary Rule). The final rule no longer singles out ESG for special consideration. Instead, it draws a roadmap for fiduciaries to consider all investments, focusing on their benefit to participants rather than their type. Under the new "pecuniary factors" analysis, material ESG factors that are used to try to improve returns or to reduce risks consistent with the plan's investment goals and objectives are prudent and appropriate for ERISA plans, including for use as QDIAs (Qualified Default Investment Alternatives). In this whitepaper we examine the requirements and background of the new Pecuniary Rule.

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Executive summary

The final Pecuniary Rule is significantly improved from the original, ESG-focused proposal. Rather than focusing on any single investment product or category, it requires ERISA plan fiduciaries and their investment advisors or managers to make investment decisions based on the pecuniary factors relevant to the investment.

- Pecuniary vs. non-pecuniary factors – The new rule clarifies that the ERISA duty of loyalty prohibits fiduciaries from subordinating the economic interests of participants to non-pecuniary objectives. In other words, fiduciaries can't sacrifice investment return or take on additional investment risk to further non-pecuniary goals. Therefore, when fiduciaries make investment decisions for ERISA plans, they must consider only pecuniary factors.
- What is a pecuniary factor? – A factor is pecuniary if a fiduciary prudently determines it is expected to have a material effect on the risk or return of an investment based on a time frame appropriate for the plan's investment objectives and goals. The weight given to a pecuniary factor by a fiduciary should appropriately reflect a prudent assessment of its impact on risk and return. DOL suggests that fiduciaries review the prospectus or similar document of an investment under consideration to understand the role of any non-pecuniary factors.
- What the new rule means for ESG-related investments – It means that ESG-related investments using ESG factors for pecuniary purposes are prudent for ERISA fiduciaries and can be used in ERISA plans. The final rule is a roadmap for prudently selecting and monitoring ESG investments, giving a green light to ESG investments that seek to improve investment outcomes for participants. For example, many modern ESG investments have "integrated" ESG factors into their investment review process. They are using these factors in an effort to reduce risk or to increase returns. This use of ESG is consistent with the final regulation.
- Are non-pecuniary factors prohibited? – No. The final rule does not prohibit Designated Investment Alternatives ("DIAs")[2] from possessing any non-pecuniary attributes, but it prevents those factors from being considered by the ERISA plan fiduciary in selecting the investment. This is an important point. The core investments on the plan menu must be selected based solely on their pecuniary factors, ignoring any non-pecuniary factors.

  The only time a non-pecuniary factor can be directly considered is when breaking a tie. If consideration of the pecuniary factors alone does not result in a final decision, then non-pecuniary factors may be considered, but the fiduciary must complete additional analysis and documentation demonstrating why this was appropriate.
- ESG-related investments can be QDIAs – In one of the most significant changes in the final rule, any type of investment that considers solely pecuniary factors may be used as a QDIA. Thus, ESG-related investments that utilize ESG factors only for pecuniary purposes may be a QDIA under the final rule. DOL does note that the prospectus or similar document should be read closely to determine if any non-pecuniary factors are considered by the investment manager.
- When do we have to comply? – All new ERISA investment decisions must follow the Pecuniary Factor rule beginning January 12, 2021. Previously made investment decisions are subject to the Rule when they are periodically reviewed after January 12. For example, if a plan's investment committee will next meet to review investments in March, it must apply the new rule to all of its investments at that meeting. There is also a longer grace period for existing QDIA investments: The rule does not apply to them until April 2022.

As a final note, the Pecuniary Factor rule will go into effect roughly one week before Inauguration Day. It is not clear whether the next administration will seek to amend or revoke the rule, or how long it might take to do so, given that the rule will already be in effect. As a result, fiduciaries should be prepared to comply with the new rule on January 12, 2021.

ERISA fiduciary duty – investment selection

The basic fiduciary duties in ERISA sections 403(c) and 404(a) require that fiduciaries must act solely in the interest of the plan's participants, and for the exclusive purpose of providing benefits and defraying the reasonable expenses of administering the plan. The issue of how to apply these basic fiduciary obligations to investments with ESG or similar features is nothing new. DOL first addressed this question in 1994, when it issued Interpretive Bulletin 94-1 (IB 94-1) to clarify the application of the DOL fiduciary investment regulations.[3]

IB 94-1, and subsequent guidance issued in 2008 (IB 08-01),[4] 2015 (IB 15-01) and 2018 (Field Assistance Bulletin 2018-01), had many common characteristics. As DOL described this guidance in the Preamble to the Final Rule, all four versions agreed that "…plan fiduciaries must be focused solely on the plan's financial returns, and the interests of plan participants and beneficiaries…" All four also all agreed that this framework permitted ESG-related investments, and that these could be prudently selected by plan fiduciaries. Where the specific documents disagreed was in exactly how to balance or document these considerations.

DOL concerns about ESG investments

Despite the relatively recent revisions to the guidance, growth in ESG investments convinced DOL that there was not enough clarity in how to apply ERISA's fiduciary standards to these types of investments. Concerned that fiduciaries may be selecting ESG investments for reasons unrelated to the participants' economic interests, DOL proposed new standards, processes and restrictions on the use of ESG-related investments in ERISA plans.

However, DOL faced a significant problem – it could not define what it meant by ESG investments. It also had not taken into account the growing integration of ESG factors into investments in ways that are intended to increase returns or reduce risks. As thousands of comments to the proposed rule pointed out, the issue was not whether ESG (or any other factors) are used by fiduciaries, but how they are used.

Regardless of their nature, some factors are material to an investment decision, and some are not. Given that ESG is not unique in this regard, and given that there was no way to define ESG products in a way that drew a distinction between their prudent use and their imprudent use, DOL recognized that it had to change the focus of the rule. As a result, all references to ESG were removed, and DOL adopted the new pecuniary vs. non-pecuniary use standard.

Combining the duties of prudence and loyalty in the final rule

The final rule is broader than just the new pecuniary factor standard. It generally restates and amends the old regulation to incorporate prudence and loyalty into plan investment decision-making. DOL acknowledges the role of modern portfolio theory in ERISA, and reiterates that an investment is not prudent or imprudent based solely on its own risk/return profile. Instead, each investment has to be judged in connection with the role it will play in the overall plan portfolio.

The final rule starts by requiring, when selecting investments, that fiduciaries must:
Act solely in the interests of participants and beneficiaries
Act for the exclusive purpose of providing benefits and defraying reasonable expenses of administering the plan
Act with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims

"Appropriate consideration" includes:
A determination by the fiduciary that the investment is reasonably designed to further the purposes of the plan, taking into consideration its risk/return characteristics compared to those of similar "reasonably available alternatives"
Consideration of diversification, liquidity, current return relative to the anticipated cash flow requirements of the plan, the projected return relative to the funding objectives of the plan, and how the investment compares to alternatives considered

Helpfully, DOL reiterates that fiduciaries need not "scour the market" or consider every alternative, but are to compare alternatives that are reasonably available under the circumstances.

Pecuniary and non-pecuniary factors

The final rule then adopts the new pecuniary factors analysis. This is stated both as a positive obligation (to consider only pecuniary factors) and as a negative prohibition (fiduciaries may not subordinate the interests of participants to non-pecuniary considerations).

ERISA fiduciaries must evaluate investments based solely on pecuniary factors. In defining "pecuniary factors," the final rule removes the proposal's concept of materiality under "generally accepted investment theories." Instead, a pecuniary factor is 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 time horizons consistent with the plan's investment objectives and its funding policy. The weight given to any pecuniary factor by a fiduciary should appropriately reflect a prudent assessment of its impact on risk/return.

In addition, fiduciaries are prohibited from subordinating the interests of participants to unrelated non-pecuniary objectives. Specifically, a fiduciary cannot sacrifice investment returns or take additional investment risk to promote non-pecuniary goals.

The non-pecuniary exception

The final rule provides one exception to the prohibition on considering non-pecuniary factors. They may be used to make a decision where the fiduciary is unable to distinguish between investment alternatives on the basis of pecuniary factors alone. If a fiduciary is unable to determine which investment is in the best interests of the plan on the basis of pecuniary factors alone, the fiduciary may base the investment decision on non-pecuniary factors, provided the fiduciary documents:

- Why pecuniary factors were not sufficient to decide
- How the investment compares to the alternatives
- How the chosen non-pecuniary factors are in the best interest of the participants' retirement income or financial benefits under the plan

Pecuniary uses of ESG

While there are ESG investments that sacrifice return for non-pecuniary goals, these funds have never been permitted under DOL's prior guidance. Many ESG investments under consideration by ERISA plans integrate ESG factors into overall investment analytics in order to try to improve fund performance, diversify investments and reduce risk. Scholars and industry groups studying ESG investments continue to gather evidence showing that ESG considerations can reduce risk and increase risk-adjusted returns. When used in this way, these ESG factors serve the economic interests of participants and would appear to be pecuniary factors.

For example, a 2015 *Journal of Sustainable Finance and Investment* review of the primary and secondary data from roughly 2,200 previous academic review studies found that "…the business case for ESG investing is empirically very well founded. Roughly 90% of studies find a nonnegative ESG – [Corporate Financial Performance] relation."[6] Another study found that the top quintile of companies rated on ESG factors outperformed the bottom quintile by 3 percentage points.[7] A Morgan Stanley survey of nearly 11,000 funds from 2004 to 2018 compared sustainable funds to traditional funds. It found that sustainable fund returns were comparable to traditional funds, but reduced downside risk and lowered volatility.[8]

A fiduciary selecting an investment for an individual plan will need to review the prospectus or similar investment description to determine whether and how various investment factors are used by the investment manager. The Preamble to the final rule suggests that DOL believes these descriptions will provide important information to fiduciaries to assess the materiality of these factors, including ESG factors.

Non-pecuniary factors may be present, but not considered, in DIAs

Strategic, qualitative diversification in the final rule focuses on the factors used to select the investment. The rule does not categorically prohibit the selection of a DIA that has some non-pecuniary goals, if the participants may chose the DIA from a broad range of investment alternatives. The rule is very clear, however, that the fiduciaries must select the investment based solely on pecuniary factors and without regard to the non-pecuniary factors.

QDIAs and pecuniary factors

Because the final rule is neutral as to types of investment products, ESG investments are fully eligible to be prudently selected as QDIAs. The issue is whether the QDIA's "…investment objectives or goals or its principal investment strategies include, consider, or indicate the use of one or more non-pecuniary factors." This is a different standard than the language of the general pecuniary factors test used for DIAs. Specifically, the QDIA cannot "include," "consider" or "indicate the use of" a non-pecuniary factor in its "objectives," "goals" or "principal strategies." Unlike the DIA selection process, which may result in an investment with some non-pecuniary goals as long as they were not considered in its selection, in QDIA selection, the limitation on non-pecuniary factors is focused on the internal management of the investment itself.

DOL notes in the Preamble that "Fiduciaries should be particularly cautious in exercising their diligence obligations under ERISA when disclosures, whether in prospectuses or marketing materials, contain references to non-pecuniary factors or collateral benefits in a fund's investment objectives or goals or its principal investment strategies."[9] DOL highlights that certain securities law disclosures might reference "an ESG or sustainability rating system or index… and [if] that ratings system or index evaluates one or more factors that are not financially material to investments (i.e., evaluates non-pecuniary factors)…" then they may not be eligible as a QDIA.[10]

Political environment and effective date

The Pecuniary Rule will go into effect on January 12, 2021, roughly a week prior to the inauguration of the president on January 20. As a result, the rule will already be in effect when the next president takes office. The Administrative Procedure Act governs federal rulemaking, and while it provides some more aggressive options for suspending the application of the rule, it would be harder for the next administration to reverse a rule that is already in effect. Further, as of this writing, it is not clear which political party will control the Senate. If the Congress is controlled by the same party as the president, the Congressional Review Act would allow the rule to be struck down by a congressional resolution. Thus, we do not know whether the Pecuniary Rule will remain in its current form.

Conclusion

The Pecuniary Final Rule is a significant improvement on the proposed ESG-based rule. It treats all investments the same, focusing on how a fiduciary considers investment factors rather than which type of investment product is being reviewed. However, plan fiduciaries and their advisors will need to change their investment review processes to ensure compliance with the new rule, and part of that will be a close review of the prospectus or other document describing the investment. Non-pecuniary factors may be difficult to discern with respect to some QDIA decisions.

FOOTNOTES

1. DOL received 1,100 individual comment letters and 7,617 names associated with 6 petitions. It is likely that many more comments were received after the deadline and have not been released by DOL.

2 Designated Investment Alternatives are those investments selected by the plan fiduciaries for the plan menu that are available to participants.

3 See 29 CFR 2550.404a-1.

4 In the interest of full disclosure, the author promulgated IB 08-01 while serving as U.S. Assistant Secretary of Labor for Employee Benefits.

5 85 Fed. Reg. 72,847 (November 13, 2020).

6 "ESG and Financial Performance: Aggregated Evidence from More than 2000 Empirical Studies," Journal of Sustainable Finance and Investment, 2015.

7 MSCI ESG Research LLC, FactSet, Refinitiv, Sustainalytics, BofA Global Research U.S. Equity & Quant Strategy.

8 "Sustainable Reality: Analyzing Risk and Returns of Sustainable Funds," Morgan Stanley report, 2019.

9 85 Fed. Reg. 72,864.

10 Id. at 72,866.

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