WILLKIE FARR & GALLAGHER LLP

CLIENT ALERT

DOL Issues Proposed Rule Highlighting Factors to Consider When Making ESG Investments for ERISA Plans

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I. Overview

On June 23, 2020, the Department of Labor (the "DOL") released a proposal to amend certain provisions of the "investment duties" regulation (the "Proposed Rule") under the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), to clarify the circumstances under which a fiduciary of a plan that is subject to ERISA may consider investments that include non-pecuniary objectives, such as environmental, social and governance ("ESG") factors or other public policy goals. The Proposed Rule confirms the DOL's long-standing position that ERISA plan fiduciaries are required to make investment decisions based on "complete and undivided loyalty" and with an "eye single" to the interests of ERISA plan participants and beneficiaries. The Supreme Court has unanimously held that in the context of retirement plans, such interests refer to "financial" rather than "non-pecuniary" benefits.[1]

[1] Fifth Third Bancorp v. Dudenhoeffer, 573 U.S. 409 (2014).

II. Background and Prior DOL Guidance

ERISA establishes certain minimum standards for plan fiduciaries, including that plan fiduciaries act "solely" in the interest of plan participants and beneficiaries and for the "exclusive purpose" of providing benefits to such plan participants and beneficiaries and defraying reasonable expenses.[2] Under these principles, fiduciaries would violate ERISA if they sacrifice investment returns, take on greater investment risk, or pay higher fees to promote non-pecuniary goals, such as ESG factors. Prior guidance from the DOL concerning the application of such principles to investment decisions permitted fiduciaries to consider collateral benefits as a "tiebreaker" when deciding between two economically equivalent investment choices (also referred to as the "all things being equal" test).

In 2015, the DOL issued guidance restating the "all things being equal" test, including that the economic considerations that form the basis of a prudent investment decision may derive from ESG factors. However, just three years later, the DOL clarified that its earlier guidance simply acknowledged that there may be instances where qualified investment professionals could treat ESG factors as economic considerations under generally accepted investment theories. The DOL further advised that even when ESG factors may be appropriately characterized as economic considerations, such factors should be weighted to the relative level of risk and return involved compared to other relevant economic factors.

III. ESG Investing

The Proposed Rule cites the increased emphasis on ESG investments in the marketplace and the DOL's concern that plan fiduciaries may be prompted to make investment decisions on the basis of criteria unrelated to financial performance. In particular, the DOL notes the lack of a consensus about what actually constitutes an ESG investment and the "often vague and inconsistent" rating systems for ESG investments. As a result, the DOL notes that ESG investments oftentimes incur higher fees related to the monitoring and diligence of the investment.[3]

IV. Summary of the Proposed Rule

The Proposed Rule would add a new provision to the "investment duties" guidance in the DOL's regulations and make explicit that a fiduciary's evaluation of an investment should focus solely on "financial" or "pecuniary" factors that have a material effect on the return and risk of an investment. The Proposed Rule would also add a new provision making clear that a fiduciary may not sacrifice financial returns or accept additional risk to promote a non-pecuniary goal. Consistent with the DOL's earlier guidance, the Proposed Rule acknowledges that environmental, social, corporate governance or other similarly oriented considerations may be considered pecuniary factors, and therefore valid economic considerations, but only if such factors present material economic risks or opportunities under generally accepted investment theories. In

[2] Section 404(a)(1)(A) of ERISA.

[3] The Proposed Rule also notes that the current examination priorities for the Securities and Exchange Commission for 2020 include a focus on ESG funds.

those cases, the weight given to the ESG factors should reflect a prudent assessment of their impact on risk and return. Other factors that the fiduciary should consider include the level of portfolio diversification, degree of liquidity, and potential risk and return in comparison with other available investment alternatives. The DOL cautioned, however, that fiduciaries must not too readily treat ESG factors as constituting relevant economic factors, and instead must always put the economic interests of the plan first.

Under the Proposed Rule, the DOL acknowledges that because ties may theoretically occur when alternative investments appear economically indistinguishable, a fiduciary may rely on a non-pecuniary factor as a “tiebreaker.” However, in this case, the Proposed Rule requires the fiduciary to adequately document the basis for concluding that a distinguishing factor could not be found (i.e., why it was truly a “tie”) and why the selected investment was chosen. The DOL noted that this documentation requirement is intended to ensure that fiduciaries do not improperly rely on the “tiebreaker” or “all things being equal” test when making investment decisions that consider non-pecuniary factors.

With respect to selecting investment alternatives for participant-directed individual account plans, such as 401(k) plans, the Proposed Rule provides that a prudently selected, well-managed, and properly diversified fund with ESG investment mandates can be added to an individual account plan platform without having to forgo adding other non-ESG investment options. However, including an ESG-focused fund to an individual account plan investment lineup is permissible only if the fiduciary makes its selection using objective risk-return criteria (including benchmarks, expense ratios, fund size, long-term investment returns, volatility measures, manager experience and philosophy and asset types) and also documents the basis of its selection and monitoring of the investment. The Proposed Rule also clarifies that an ESG-oriented investment may not serve as the “qualified default investment alternative,” or QDIA, for an individual account plan.

The Proposed Rule includes a 30-day comment period. We will continue to provide updates as the rulemaking process for ESG investments progresses.

If you have any questions regarding this client alert, please contact the following attorneys or the Willkie attorney with whom you regularly work.

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