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DOL Finalizes Rule on Retirement Plan Investment Selection, Removing References to ESG Investments

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Investment Company Directors
ICI Global Members
ESG Task Force (Global)
ESG Working Group (US)
ICI Global Retirement Savings Committee
Pension Committee
Pension Operations Advisory Committee SUBJECTS: ESG
Pension RE: DOL Finalizes Rule on Retirement Plan Investment Selection, Removing References to ESG Investments

On October 30, 2020, the Department of Labor (DOL) released its final rule amending the existing regulation on fiduciary standards for selecting and monitoring investments.[1] DOL explains that the rule is intended to provide clear regulatory guideposts for retirement plan fiduciaries in light of recent trends involving environmental, social and governance (ESG) investing.[2]

As described in more detail below, the final rule is substantially improved from DOL's proposed rule (the "Proposal"), for which ICI voiced strong opposition.[3] Most significantly, the text of the final rule contains no specific references to ESG or ESG-themed funds and, instead, refers to "pecuniary" and "non-pecuniary" factors in defining the relevant fiduciary investment inquiry. Nonetheless, the final rule continues to place new burdens on plan fiduciaries when an investment or an investment course of action takes into account non-pecuniary factors. The preamble, for example, "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"[4] and, as explained below, continues to require documentation in the case of using non-pecuniary factors to as "tie-breakers" when alternative investments are determined to be *economically indistinguishable*.

Overview of Final Rule

Like the Proposal, the final rule amends DOL's existing regulation that describes a

fiduciary's investment duties under ERISA. The rule reiterates the basic requirements that, in selecting plan investments, a fiduciary is subject to ERISA's duties of prudence and loyalty. The final rule provides that ERISA fiduciaries must evaluate investments and investment courses of action based solely on pecuniary factors—*i.e.*, factors that the responsible fiduciary prudently determines are expected to have a material effect on risk and/or return of an investment based on appropriate investment horizons consistent with the plan's investment objectives and the funding policy. The final rule also states that the duty of loyalty prohibits fiduciaries from subordinating the interests of participants to unrelated objectives and bars them from sacrificing investment return or taking on additional investment risk to promote non-pecuniary goals.

Key Changes from Proposal

The final rule adopts the Proposal with a number of significant and mostly helpful modifications in response to comments it received. More specifically, the final rule includes the following changes:

1. Removes all ESG terminology from the regulatory text. Unlike the Proposal, the final rule's operative text contains no specific references to ESG or ESG-themed funds. According to DOL, it concluded "that the lack of a precise or generally accepted definition of 'ESG,' either collectively or separately as 'E, S, and G,' made ESG terminology not appropriate as a regulatory standard. Instead, the final rule refers to pecuniary factors and non-pecuniary factors in defining the relevant fiduciary investment duties."[5] This means that a plan fiduciary could incorporate ESG factors in their evaluation of investments and investment courses of action so long as such factors are pecuniary factors—*i.e.*, factors that the responsible fiduciary prudently determines are expected to have a material effect on risk and/or return of an investment based on appropriate investment horizons consistent with the plan's investment objectives and the funding policy.[6]

2. Modifies application of rule to 401(k) plans. The final rule does not prohibit fiduciaries of participant directed individual account plans from considering or including, as designated investment alternatives, investment funds, products, or model portfolios that support non-pecuniary goals if the plans allow participants and beneficiaries to choose from a broad range of investment alternatives, provided, however, that the rule's requirements related to prudence and loyalty are met, including the requirement to evaluate investments solely based on pecuniary factors when selecting any such investment fund, product, or model portfolio (and subject to the final rule's special rule for QDIAs, described below). DOL removed the provisions in the Proposal that would have required that a fiduciary (1) use only objective risk-return criteria and (2) document its selection and monitoring decisions, for any investment that included "one or more environmental, social, corporate governance, or similarly oriented assessments or judgments in their investment mandates, or that include these parameters in the fund name."

3. Modifies special rules for qualified default investment alternatives (QDIAs). The Proposal would have banned any investment containing an ESG-type of mandate from being a QDIA even if it was selected using only objective risk-return criteria and was otherwise prudent.[7] The final rule modifies this provision, prohibiting plans from adding or retaining any investment fund, product, or model portfolio as a QDIA, or as a component of a QDIA, if its objectives or goals or its principal investment strategies include, consider, or indicate the use of one or more non-pecuniary factors. In making

this change, DOL acknowledges that individual ESG factors can be both pecuniary and non-pecuniary in nature, and that the selection of ESG funds is not per se prudent or imprudent.[8] DOL further comments that a plan fiduciary can apply this test objectively without difficulty, for instance, by simply looking at the investment fund's prospectus to determine whether the fund is subject to the prohibition on its use as a QDIA or as a component investment of a QDIA.[9]

4. Simplifies tie-breaker test. Under the Proposal, DOL would have allowed non-pecuniary factors to be considered only when alternative investments are determined to be *economically indistinguishable*. In the final rule, DOL has simplified the tie-breaker test, providing that non-pecuniary factors may be considered "when choosing between or among investment alternatives that the plan fiduciary is unable to distinguish on the basis of pecuniary factors alone." In the preamble, DOL confirms that the provision is not meant to demand "that investments be identical in each and every respect before the tie-breaker provision would be available."[10]

5. Removes documentation requirement unless selected under the tie-breaker rule. The final rule includes documentation requirements for circumstances in which plan fiduciaries use non-pecuniary factors to choose between or among investments that the fiduciary cannot distinguish based on pecuniary factors alone (*i.e.*, when a fiduciary selects an investment using this tie breaker rule). If nonpecuniary factors are used as a tie-breaker, the fiduciary must document the following items:
    - Why pecuniary factors were not sufficient to select the investment or investment course of action;
    - How the selected investment compares to the alternative investments with regard to the same factors that must be considered under the prudence safe harbor; and
    - 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 notes that responding to participant demand for certain investment options could be one example of a factor that is consistent with participants' interests in this regard.[11])

   The Proposal had included a much broader requirement that a fiduciary of a participant-directed defined contribution plan document its selection and monitoring of any investment that include one or more environmental, social, corporate governance, or similarly oriented assessments or judgments in their investment mandates, or that include these parameters in the fund name.[12] Despite including a tie-breaker test, DOL encourages fiduciaries to "make their best judgment" on the basis of pecuniary factors alone, including, where prudent, to diversify by selecting all indistinguishable alternatives.

6. Restores original safe harbor for duty of prudence. Prior to the amendment, the regulation made clear that the regulation was a safe harbor; however, it was not clear whether any aspect of the Proposal was to be considered a safe harbor. ICI's Letter raised this point and asked DOL to address this issue.[13] In response to comments, DOL restored the original safe harbor for satisfying the fiduciary's duty of prudence when carrying out its investment duties.[14] The other provisions of the rule (including a new provision describing minimum requirements for meeting the statutory standard of loyalty under ERISA) are legal requirements and not a safe harbor.

7. Modifies requirement to compare alternatives. Significantly, DOL modified the

requirement that the fiduciary consider how the investment compares to available alternative investments with regard to listed factors. ICI's Letter had argued that a generally applicable requirement to always compare investments would lead to unnecessary confusion and would necessitate detailed guidance from DOL.[15] In the final rule, DOL provides that, in meeting the safe harbor for satisfying the duty of prudence, a fiduciary must take into consideration the risk of loss and the opportunity for gain associated with the investment *compared to the opportunity for gain (or other return) associated with reasonably available alternatives with similar risks*.[16] In the preamble, DOL explains that it "used the phrase 'reasonably available alternatives' not only to confirm that the rule does not require fiduciaries to scour the market or to consider every possible alternative, but also to allow for the possibility that the characteristics and purposes served by a given investment or investment course of action may be sufficiently rare that a fiduciary could prudently determine, and document, that there were no other reasonably available alternatives for purpose of this comparison requirement."[17]

8. Carves out brokerage windows from rule. The final rule applies to a fiduciary's selection or retention of designated investment alternatives and includes a definition of "designated investment alternative," which clarifies that the term does not include "brokerage windows," "self-directed brokerage accounts," or similar plan arrangements that enable participants and beneficiaries to select investments beyond those designated by the plan.

Effective Date

The final rule will be effective 60 days after publication, but DOL gives plans until April 30, 2022 to make any changes that are necessary to comply with the requirements related to the selection of QDIAs.[18]

Significantly, DOL explains that the rule will apply prospectively to investment decisions (including decisions that are part of ongoing monitoring requirements) made after the effective date and that plan fiduciaries "are not required to divest or cease any existing investment, investment course of action, or designated investment alternative, even if originally selected using non-pecuniary factors in a manner prohibited by the final rule."[19] Further, DOL states that it will not pursue enforcement pertaining to any action taken or decision made with respect to an investment by a plan fiduciary prior to the effective date to the extent that such enforcement action would necessarily rely on citation to the final rule.[20]

Shannon Salinas
Associate General Counsel - Retirement Policy

endnotes

[1] The final rule is *available at* https://www.dol.gov/sites/dolgov/files/EBSA/temporary-postings/financial-factors-in-selecting-plan-investments-final-rule.pdf. DOL's fact sheet on the final rule is *available at* https://www.dol.gov/agencies/ebsa/about-ebsa/our-activities/resource-center/fact-sheets/final-rule-on-financial-factors-in-selecting-plan-investments, and DOL's press release is

available at https://www.dol.gov/newsroom/releases/ebsa/ebsa20201030.

[2] DOL explains "The purpose of this action is to set forth a regulatory structure to assist ERISA fiduciaries in navigating these ESG investment trends and to separate the legitimate use of risk-return factors from inappropriate investments that sacrifice investment return, increase costs, or assume additional investment risk to promote non-pecuniary benefits or objectives." Preamble at page 11.

[3] For a summary of DOL's Proposal, *see* ICI Memorandum No. 32552, dated June 24, 2020, *available at* https://www.ici.org/my_ici/memorandum/memo32552. For a summary of ICI's July 30, 2020 comment letter on the Proposal ("ICI Letter"), *see* ICI Memorandum No. 32652, dated July 31, 2020, *available at* https://www.ici.org/my_ici/memorandum/memo32652. The ICI Letter argued that the Proposal ignores the fact that ESG considerations are often pecuniary in nature and that DOL should not single out one investment category for special treatment and urged DOL to withdraw the Proposal.

[4] Preamble at page 50.

[5] *See* page 4 of DOL Fact Sheet. Note that the final rule did not include the language from the Proposal that ESG considerations "are pecuniary factors only if they present economic risks or opportunities that qualified investment professionals would treat as material economic considerations under generally accepted investment theories." Section (c)(1) of Proposal. Instead DOL has decided to "rely on the definition of pecuniary factor as the governor for investment decisions without specifically constraining the criteria that a fiduciary could consider in making a prudent judgment." *See* preamble at page 48.

[6] DOL acknowledges that it understands that "at least some ESG factors, at times, may also be pecuniary factors." Preamble at page 68. DOL explains that the rule "recognizes that there are instances where one or more environmental, social, or governance factors will present an economic business risk or opportunity that corporate officers, directors, and qualified investment professionals would appropriately treat as material economic considerations under generally accepted investment theories. For example, a company's improper disposal of hazardous waste would likely implicate business risks and opportunities, litigation exposure, and regulatory obligations. Dysfunctional corporate governance can likewise present pecuniary risk that a qualified investment professional would appropriately consider on a fact-specific basis." Preamble at page 11.

[7] ICI's Letter voiced our concern that the Proposal would explicitly prohibit the use of ESG-integrated investments as a QDIA regardless of whether such ESG criteria would constitute material economic consideration, which would serve to prohibit the use of these funds as component investments in a QDIA regardless of the merit of the fund in the creation of the QDIA's overall investment strategy. ICI Letter at page 7.

[8] Preamble at page 74.

[9] Preamble at page 75.

[10] Preamble at page 61.

[11] DOL explains that "an objective to increase contributions or respond to participant interest in investment options for their retirement savings are permissible factors to use in the tie-breaker provisions…based on their connection to the interests of the plan and plan

participants and beneficiaries." Preamble at page 54.

[12] Section (c)(3)(ii) of the Proposal. ICI's Letter noted the incongruous contrast between the DOL's recent information letter on investment in private equity, which does not create enhanced diligence or documentation requirements and the Proposal, which applied specific diligence and documentation requirements to ESG investments. ICI Letter at page 16.

[13] More specifically, our letter said "We respectfully request the Department clarify that paragraph (b) continues to be a safe harbor and not the exclusive means for satisfying a fiduciary's duty of prudence in connection with investments. If—despite the clear need to withdraw the Proposed Rule—the Department's intent is to transform paragraph (b) from a safe harbor into an affirmative requirement, then we believe that the Department must provide specific notice of this fact and solicit comments from the public while also assessing the costs and benefits of the change." *See* page 19 of ICI Letter.

[14] *See* subsection (b) of final rule, which is not substantively changed from the original regulation.

[15] *See* page 21 of ICI Letter.

[16] Compare section (b)(2)(ii)(D) of the Proposal with section (b)(i) of the final rule.

[17] Preamble at page 31.

[18] In explaining its decision not to include a delayed applicability date, DOL explains that the final rule "primarily explains existing statutory requirements and regulations with respect to the investment duties of plan fiduciaries and is not a major departure from its previous guidance on the basic investment duties of fiduciaries. Thus, the Department does not believe an overall delay in the applicability of the final rule is necessary to allow additional time for plans to prepare for the significantly scaled-back investment documentation requirements of the final rule." Preamble at page 85.

[19] Preamble at page 86.

[20] *Id*.
