

Chapman Client Alert

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Current Issues Relevant to Our Clients

DOL Finalizes Rule Regarding the Use of ESG Factors for ERISA Plan Investments

On October 30, 2020, the Department of Labor (the “DOL”) issued a final rule which amends its 1979 investment duties regulation under the Employee Retirement Income Security Act of 1974, as amended (“ERISA”), to update and clarify its position with respect to ERISA plan fiduciaries’ use of environmental, social and governance (ESG) factors in selecting investments. Over the years, the DOL’s interpretations and guidance regarding requirements with respect to the use of ESG factors has fluctuated depending on the administration in power. The final rule provides the current DOL’s position regarding the use of ESG factors in selecting ERISA plan investments. The main principle of the final rule is that ERISA plan fiduciaries must only consider financial risks and/or returns and interests of plan participants and beneficiaries when selecting particular investments or investment courses of action.

In summary, the final rule requires ERISA plan fiduciaries to evaluate plan investments using only pecuniary factors. However, if investments are indistinguishable based on consideration of pecuniary factors, the plan fiduciary may consider non-pecuniary factors. Plan fiduciaries must consider only pecuniary factors when selecting a menu of investments for a defined contribution plan (e.g., a 401(k) plan). Finally, the final rule prohibits the selection of an investment to be used as a qualified default investment alternative (QDIA) under a defined contribution plan if such investment considers or uses non-pecuniary factors.

The rule includes some differences from the proposed rule, which was published on June 30, 2020. However, even after significant public comments that mostly opposed the restrictions that the DOL imposed on ESG investing, the substance of the proposed rule remains largely intact. Notably, the final rule no longer explicitly refers to “ESG.” The rationale for this revision generally was to prevent consideration of non-pecuniary factors, which are not limited to ESG factors. In other words, the final rule does not specifically prohibit investments that involve ESG strategies as long as plan fiduciaries only use “pecuniary” factors when evaluating investments.

In addition to removing the specific “ESG” references, the final rule does the following:

- The final rule incorporates the fiduciary duty of loyalty by providing that a fiduciary’s evaluation of an investment or investment course of action must be based solely on pecuniary factors. A “pecuniary factor” is defined as “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 funding policy.” That is, an ERISA fiduciary must generally base its investment decisions for a plan on economic considerations. The duty of loyalty provides that a fiduciary may not subordinate the interests of participants and beneficiaries in their retirement income or financial benefits under the plan to other objectives (e.g., ESG objectives), and may not sacrifice investment return or take on additional investment risk to promote non-pecuniary benefits or goals.

- The final rule also provides that a fiduciary must consider whether a “particular investment or investment course of action is reasonably designed, as part of a portfolio. . . to further the purposes of the plan, taking into consideration the risk of loss and the opportunity for gain (or other return) associated with the investment or investment course of action **compared to the opportunity for gain (or other return) associated with reasonably available alternatives with similar risks. . .**” (emphasis added). The highlighted language was added in the final rule. Thus, a fiduciary is not required to “scour the market” and consider every possible alternative. The DOL indicated that it is possible that the characteristics and purposes served by a given investment may be sufficiently rare that a fiduciary could prudently determine, and document, that there were no other reasonably available alternatives for purposes of the comparison requirement.
- If an ERISA fiduciary cannot distinguish among investments based on pecuniary factors, the fiduciary may consider non-pecuniary factors to select investments. In order to select an investment under this “tie-breaker” rule,

the fiduciary must document the following: (1) why pecuniary factors were not sufficient to select the investment, (2) how the investment compares to alternative investments with regard to composition, liquidity, and returns; and (3) how the chosen non-pecuniary factors are consistent with the interests of the plan. Notwithstanding the “tie-breaker” rule, the DOL indicated that it believes that it would be very rare to conclude that investment options cannot be distinguished on the basis of pecuniary factors.

- The final rule added a new provision regarding a fiduciary’s selection of investments for a defined contribution individual account plan, such as a 401(k) plan. The final rule provides that the same prudence and loyalty standards that apply to the selection of individual investments or investment strategies also apply to the selection of designated investment alternatives to be offered under an individual account plan. Essentially, the final rule requires plan fiduciaries to select investment options under such plan by relying solely on pecuniary factors. The final rule retains the proposed rule’s prohibition against selecting an investment as a qualified default investment alternative (QDIA) if such investment

has objectives, goals or principal investment strategies that include one or more non-pecuniary factors.

The final rule applies prospectively and will generally be effective 60 days after publication in the *Federal Register*. Although the final rule makes a few changes to the proposed rule, it is likely that critics of the proposed rule will still oppose the final rule. It will be interesting to see whether a future Democratic administration will make changes to the final rule. In the meantime, however, ERISA plan fiduciaries should consider the impact of the final rule on its investments and investment strategies.

[For More Information](#)

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