

DOL Finalizes New Regulation Regarding Investment Duties

On October 30th, the Department of Labor (the “DOL”) finalized its investment duties regulation under ERISA. The final regulations require plan fiduciaries to select investments and investment courses of action based solely on financial considerations relevant to the risk-adjusted economic value of a particular investment or investment course of action. While the proposed version of the regulation focused specifically on environmental, social, and corporate governance (ESG) investing, the final version has removed any reference to ESG terminology. Instead, the final regulation sets forth fiduciary standards for selecting and monitoring investments held by ERISA plans, and addresses the scope of fiduciary duties surrounding non-pecuniary issues.

On March 10, 2021, the DOL issued a statement that, until further notice, it will not bring any enforcement actions against ERISA fiduciaries based on their failure to comply with the terms of the final regulation. The DOL has not provided a time frame for when any future guidance will be released. Until then, investment fiduciaries should consider the terms of the final rule, and the DOL’s nonenforcement policy, when reviewing invest policies and procedures as well as selecting plan investments.

Not Your Father’s Socially Responsible Investing

When the concept of socially responsible investing began decades ago, it focused on excluding certain types of investments. The concept involved screening out companies that were involved in specific prohibited industries, such as tobacco, alcohol or weapons, or companies located in certain countries. But the concept evolved away from excluding certain investments to favoring certain investments based on a company’s ESG principles to generate competitive long term returns along with a positive societal impact.

From the perspective of an ERISA fiduciary, this shift creates some breathing room. The idea of excluding a potentially more lucrative investment because of the business they’re in seems to run contrary to the fiduciary’s duty of loyalty, which requires the best interest of the participants and beneficiaries to be paramount. But any process that considers how ESG factors might negatively impact the company’s bottom line could be complimentary to that duty of loyalty. For example, when a company has engaged in the improper disposal of hazardous waste, that fact could involve business risk, possible litigation and regulatory fines. Considering the negative impact those developments could have on the company’s bottom line would appear to make sense from a fiduciary perspective.

The DOL acknowledges the increase in the number of ESG focused investment funds, as well as the amount of money flowing into those funds. The number of ESG metrics, services and ratings offered

by third party service providers has also spiraled. The DOL knows that the speed of these trends is increasing. While not expressly mentioning ESG factors, the final regulation does give ERISA fiduciaries the basis for addressing this phenomenon.

The Regulation's Bottom Line

The DOL's final regulation starts by reasserting the terms of ERISA fiduciary rules. Fiduciaries are bound by ERISA to a very narrow objective – plan investments (or investment line-ups) must be prudently selected with an “eye single” to maximizing the benefits payable to participants and beneficiaries. Fiduciaries may not enlist plan assets in pursuit of other social or environmental objectives at the expense of ERISA's fundamental purpose of providing secure retirement benefits. When selecting plan investments, ERISA fiduciaries may not consider any non-pecuniary objectives.

The final rule imposes that duty on both the selection of (1) an investment fund as a plan investment, and (2) in the case of a defined contribution plan, a designated investment alternative under the plan. A pecuniary factor is anything 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 the plan's funding policy. Anything else would be a “non-pecuniary” factor. Nevertheless, the preamble to the final regulation indicates that ESG factors could be pecuniary in nature and that, in such cases, fiduciaries properly could consider the factors as part of their investment analysis.

The preamble to the final regulations acknowledges that dysfunctional corporate governance can present pecuniary risk that a qualified investment professional could appropriately consider on a case by case basis. The rule does not prohibit that consideration. The DOL 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.

Finally, the rule provides that ERISA fiduciaries must consider “reasonably available alternatives” to meet their prudence duties under ERISA. The preamble to the rule suggests that this provision means that fiduciaries need not scour the marketplace or look at an infinite number of possible alternatives as part of their evaluation.

What About the Tie-Breaker Rule?

Under prior guidance (which is no longer applicable), the DOL took the position that ERISA did not prohibit the consideration of non-pecuniary factors if the investment has an expected rate of return commensurate to rates of return of available alternative investments with similar risk characteristics.

This idea was frequently referred to as the “all things being equal” standard or the “tie-breaker” test. The problem with this standard is that a true “tie” when evaluating investments is likely hypothetical, and never really happens. However, the final rule does address circumstances in which the fiduciary is unable to distinguish investments solely on the basis of pecuniary factors. In that case, the fiduciary can rely on non-pecuniary considerations if they meet some documentation requirements. Specifically, the fiduciary must document: (i) why pecuniary factors were not sufficient to select the investment; (ii) how the selected investment compares to the alternative investments with regard to diversification, liquidity and current/projected returns; and (iii) how the chosen non-pecuniary factor or factors are consistent with the interests of participants and beneficiaries in their retirement benefits under the plan. In the unlikely event of a situation where “all things are equal” between two investments, fiduciaries must follow those documentation steps before considering any non-pecuniary factors.

ESG Factors in Qualified Default Investment Alternatives (“QDIAs”)?

Under the terms of the final regulation, could fiduciaries continue to allow ESG funds in a plan’s investment line-up? When selecting or monitoring an investment line-up for a defined contribution plan, the new rule provides that a fiduciary is not prohibited from including an investment in the line-up solely because the investment promotes, seeks, or supports one or more non-pecuniary goals. However, the fiduciary must satisfy the requirements discussed above. Specifically, the fiduciary cannot consider any non-pecuniary factors in the decision process.

But the final regulations are clear that no investment fund can be retained as a QDIA (or as a component of a QDIA) if its investment strategies consider non-pecuniary factors. So the final rule would require any plans that use an ESG fund as their QDIA, or that have a QDIA that includes an ESG fund, to make a switch. Under the final rule, the investment fiduciary would need to prudently conclude that the ESG factors considered by the funds are strictly pecuniary in nature to keep that QDIA fund. But that course might require thorough investigation and documentation. Fortunately, the rule gives investment fiduciaries until April 30, 2022 to make that required adjustment to their QDIA.

How Does the DOL’s Nonenforcement Announcement Impact Fiduciaries?

The final regulation became effective in early 2021. However, on March 10, 2021, the DOL issued a nonenforcement statement. The DOL announcement indicates that the Department intends to revisit the final regulation. Until any further guidance is released, the DOL will not engage any enforcement actions against investment fiduciaries based on their failure to comply with the terms of the final regulations. That nonenforcement policy extends to the entire rule, including the final regulation’s standards for QDIAs.



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The DOL's statement makes clear that this nonenforcement policy does not preclude the enforcement of any ERISA requirement, including the duties of prudence and loyalty that are central to the final regulation. It also creates a gap, leaving no clear DOL standards surrounding use of ESG focused investments in a qualified retirement plan. As a result, ERISA investment fiduciaries should continue to follow a prudent process when selecting investments, especially ESG focused investments. As always, careful documentation should support any investment process and related decisions.

Gallagher Insight

Interest in socially responsible investments – both by retirement plans and individual investors – has grown significantly in recent years. The DOL's final regulations might have given retirement plan fiduciaries some pause in using these investments going forward. Nevertheless, even following the DOL's nonenforcement statement, decisions allowing funds that consider ESG factors will require careful deliberation and documentation. ERISA fiduciaries that select ESG focused investments should probably consider documenting how ESG factors can result in better risk-adjusted investment returns. Additionally, in the event that fiduciaries have difficulty in deciding between two equally prudent investments, they may decide that observing the specific documentation required under the terms of the final rule's "tie-breaker" standard would be a best practice. Gallagher will continue to monitor developments in the DOL's position relating to socially responsible investing.

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