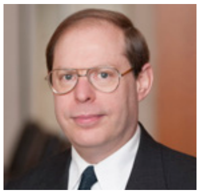
Practical Guidance

Latest Volley in ESG Back and Forth: DOL Finalizes "Financial Factors" Rule

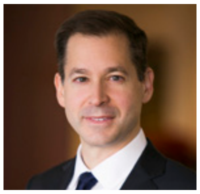
A Practical Guidance® Practice Note by Michael B. Richman, Julie K. Stapel, Elizabeth S. Goldberg, and Craig A. Bitman, Morgan, Lewis & Bockius LLP



Michael B. Richman
Morgan, Lewis & Bockius LLP

Julie K. Stapel
Morgan, Lewis & Bockius LLP

Elizabeth S. Goldberg
Morgan, Lewis & Bockius LLP



Craig A. Bitman
Morgan, Lewis & Bockius LLP

This article concerns an important development recently made in the U.S. Department of Labor's (DOL's) efforts to regulate ERISA plan fiduciaries' use of environmental, social, and governance (ESG) factors in investment decision-making. On October 30, 2020, the DOL announced publication of the final version of its Financial Factors in Selecting Plan Investments rule (the Rule). 85 Fed. Reg. 72,846 (Nov. 13, 2020). A fact sheet is also available.

DOL Guidance on Plan Investment Factors

The DOL has been issuing various forms of guidance on the topic of using ESG factors in making fiduciary decisions over the last two and a half decades, with successive administrations altering interpretations. That back-and-forth guidance has consistently mandated that plan fiduciaries make investment decisions solely in the interest of plan participants, but how ESG factors fit into that decision-making, as well as the tone and nuances, have varied with the issuing administration.

The current DOL has now staked out its position with the finalization of the Rule, which is largely seen as cautious (if not negative) on the use of ESG factors by ERISA plan fiduciaries.

As with the DOL's proposal in June, the final Rule interprets ERISA's fiduciary duties under ERISA Section 404(a)(1) with respect to investment decisions, with a focus on the duty of loyalty. It primarily does so by adding a requirement that investment decisions be based only on "pecuniary factors" except in very limited circumstances. See 85 Fed. Reg. 39,113 (June 30, 2020).

For this purpose, the Rule defines "pecuniary factor" 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 the funding policy established pursuant to section 402(b)(1) of ERISA." In other words, the Rule seeks to frame the fiduciaries' duties as permitting only economic evaluations except in limited circumstances, and to impose gatekeeping (in the form of procedural and documentation requirements) around those limited circumstances.

General Takeaways from the Final Rule

While we will provide a more in-depth analysis of the Rule soon, a few points are immediately notable about the Rule.

No Specific References to Environmental, Social or Governance

Most significantly, although the DOL is viewed as seeking to regulate ESG investing (and describes the Rule accordingly in the preamble), in contrast to the proposed rule, the final Rule itself does not include the words "environmental," "social," or "governance." In removing the specific reference to ESG from the final regulatory text, the DOL clarified that the Rule was intended to regulate reliance on nonpecuniary factors, which are not limited to ESG. The DOL also clarified in announcing the Rule 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."

This change is a helpful clarification because it removes an interpretation (that some feared the DOL was making) that ESG factors are presumptively not pecuniary. Under the Rule, then, certain ESG factors can be viewed as performance-oriented, so long as the fiduciaries determine the factors can have "a material effect on the risk and/or return of an investment based on appropriate investment horizons." The preamble emphasizes this point, observing that "the selection of ESG funds is not per se prudent or imprudent."

Use of Tie-Breaker Test

Another point of note is that in its final form, the Rule retains a modified version of a "tie-breaker" test as one of the exceptions for determining when nonpecuniary factors may be considered. This framing harkens back to earlier DOL guidance whereby "economically targeted investments (ETIs)" were permitted only as a tie-breaker. See 59 Fed. Reg. 32,606 (June 23, 1994) (appearing in the Code of Federal Regulations as 29 C.F.R. § 2509.94-1 or IB 94-1).

Plans are Not Precluded from Offering any Investment Vehicle that "Promotes, Seeks, or Supports One or More Non-pecuniary Goals

The Rule retains the interpretation in the proposed Rule that, subject to general compliance with the ERISA fiduciary duties of loyalty and prudence, participant-directed defined contribution plans are not precluded from offering an investment vehicle that "promotes, seeks, or supports one or more non-pecuniary goals," i.e., ESG-themed funds. However, the Rule continues to prohibit investment alternatives (or components of an alternative) that have nonpecuniary investment objectives or principal strategies from being a qualified default investment alternative (QDIA) (or added to a QDIA).

Effective Date

The Rule becomes effective 60 days after its publication in the Federal Register. As the Rule was published on November 13, 2020, the 60-day period ends on January 12, 2021, and the prior regulations under 29 C.F.R. § 2520.404a-1 will apply through that date. However, plans have until April 20, 2022 to make any changes in their selections of qualified default investment alternatives (QDIAs) selected under 29 C.F.R. § 2550.404c-5. 85 Fed. Reg. 72,868-72,869. However, this post having been made available on Election Day 2020 is fitting because the ultimate impact of the Rule, and whether it remains in place as finalized may be in flux, given the ongoing political nature of this regulatory interpretation.

Related Content

Lexis

- ARTICLE: Reconciling Fiduciary Duty and Social Conscience: The Law and Economics of ESG Investing by a Trustee, 72 Stan. L. Rev. 381
- ARTICLE: ENVIRONMENTAL, SOCIAL, AND GOVERNANCE ISSUES: AN ALTERED SHAREHOLDER ACTIVIST PARADIGM, 44 Vt. L. Rev. 493
- ARTICLE: Risk-Related Activism: The Business Case for Monitoring Nonfinancial Risk, 41 Iowa J. Corp. L. 647
- ARTICLE: Now Is the Time to Designate Proxy Advisors as Fiduciaries under ERISA, 25 Stan. J.L. Bus. & Fin. 1
- ARTICLE: MUTUAL FUND VOTING OF PORTFOLIO SHARES: WHY NOT DISCLOSE? 23 Cardozo L. Rev. 1419

Practical Guidance

Practice Notes

- ERISA Fiduciary Duties
- Investment Committee Issues for Defined Contribution Plans
- Alternatives to Using Target Date Funds as QDIAs

Articles

- DOL's Proposed New Proxy Voting Rule Could Be a Game Changer for ERISA Fiduciaries

Michael B. Richman, Partner, Lewis & Bockius LLP

Michael B. Richman counsels clients on the fiduciary responsibility rules under the Employee Retirement Income Security Act (ERISA), including the ERISA prohibited transaction rules. He advises plan sponsors on investment matters for defined benefit and defined contribution plans. He also counsels banks, investment adviser firms, and broker-dealer firms on ERISA compliance for ERISA plan separately-managed accounts, collective investment funds, private funds, and other arrangements. Additionally, he provides guidance to IRA custodians on permissible IRA investments and investment restrictions.

Michael also advises clients on fiduciary governance of ERISA plans, as well as on prohibited transaction and fiduciary responsibility issues in proposed transactions and transactions under government investigation. Michael prepares requests to the US Department of Labor (DOL) for prohibited transaction exemptions and advisory opinions.

Before joining Morgan Lewis, Michael was counsel in the benefits and executive compensation, and investment management groups at one of the world's largest global law firms.

A frequent writer, Michael has authored or co-authored a book, book chapters, and a number of articles on ERISA, benefits, and securities issues.

Julie K. Stapel, Partner, Morgan, Lewis & Bockius LLP

Julie K. Stapel helps employee benefit plan sponsors and financial service providers with the investment, and management of employee benefit plan assets. She advises clients on ERISA fiduciary and prohibited transaction rules, and their impact on investment products and services, and helps those clients use investment documentation and other tools to manage potential fiduciary risks while providing top-quality benefits and services. She also works with plan sponsors and financial service providers to address ERISA–related compliance issues.

Julie helps clients negotiate investment-related agreements of virtually every type, including investment management, trust, securities lending and transition management agreements, as well as many different types of trading agreements. She represents employee benefit plan investors in all types of private fund investments, negotiating fund documentation and side letters to address ERISA and other risk management issues. She also counsels financial services and investment management clients on ERISA compliance.

Co-leader of the firm's Fiduciary Duty Task Force, Julie also advises on fiduciary governance, including the formation and operation of benefit plan fiduciary committees.

She works with plan fiduciaries to implement ERISA compliance best practices and manage fiduciary risks. She also helps clients remain in compliance with ERISA's ever-changing reporting and disclosure obligations.

Julie speaks frequently on ERISA-related topics. She has spoken before the Committee on the Investment of Employee Benefit Assets (CIEBA), the ERISA Industry Committee (ERIC), the John Marshall School of Law, and at various events sponsored by *Pension and Investments* magazine. In addition to these speaking engagements, she regularly addresses client fiduciary committees and investment staff, performing fiduciary training and presenting updates on changes in the law. She is also president of the Chicago Chapter of Worldwide Employee Benefits Network (WEB).

Elizabeth S. Goldberg, Partner, Lewis & Bockius LLP

Elizabeth S. Goldberg advises clients on ERISA matters with a focus on fiduciary responsibility provisions, prohibited transaction rules and exemptions, and the management of employee benefit plan assets. She negotiates investment-related agreements on behalf of plans and financial services providers; designs, implements, and administers employee benefit plans; and counsels clients on US Department of Labor (DOL) investigations, plan fiduciary governance structures, ERISA reporting and disclosure obligations, ERISA litigation, and general benefit plan compliance considerations.

Liz came to Morgan Lewis after more than six years at the DOL's Office of the Solicitor, where she worked most recently as a senior trial lawyer litigating fiduciary breach actions under Title I of ERISA. While at DOL, Liz worked on numerous large ERISA fiduciary enforcement actions that dealt with the law's fiduciary provisions, prohibited transaction rules, ESOP transactions, and trustee duties. She also spearheaded and ran an agency pro bono program that received the 2009 Federal Agency Pro Bono Leadership Award.

Craig A. Bitman, Partner, Lewis & Bockius LLP

Craig A. Bitman provides clients with a range of knowledge and skills in all aspects of employee benefits and executive compensation law, and he also practices in the firm's institutional investor and private investment funds practices. Craig leads the firm's employee benefits and executive compensation practice and has served as a member of the firm's Advisory Board.

His client roster includes a diverse mix of businesses, trusts, and individuals, including financial services companies, public pension plans, life insurance companies, transportation and logistics providers, entertainment companies, and multiemployer trust funds. He spends a significant percentage of his time devoted to assisting these entities and individuals in complying with the Employee Retirement Income Security Act's (ERISA) complex fiduciary duties.

A member of the National Association of Public Pension Attorneys, Craig often speaks and writes on topics affecting plan sponsors and service providers. His experience in the space has earned him recognition by *Chambers USA: America's Leading Lawyers for Business*, *Best Lawyers*, *PLC*, *Legal 500* and others.