

ESG: Final Rule Issued on Financial Factors in Selecting Plan Investments

BACKGROUND

On June 30, the U.S. Department of Labor (DOL) published a proposed rule to amend the investment duties of plan fiduciaries. This proposal focused on trends toward environmental, social, and governance (ESG) considerations for retirement plan investments. The DOL expressed concerns about plan fiduciaries “making investment decisions for purposes distinct from the exclusive purpose of providing benefits to participants and beneficiaries and defraying reasonable expenses of administering the plan, and thus in violation of their fiduciary duty of loyalty.” The proposal touched a nerve and generated a flurry of public input. During the 30-day comment period, more than 1,100 written comments and more than 7,600 form letter responses were taken into account for the final rule released October 30, 2020.



ESG: environmental, social, and governance

NO FURTHER REFERENCE TO ‘ESG’

- The final rule’s text, unlike this past summer’s proposal, contains no specific references to ESG or ESG-themed funds.
- The reasoning for this shift of verbiage is “the lack of a precise or generally accepted definition of ‘ESG’... terminology not appropriate as a regulatory standard.”
- Instead, the DOL states that plan fiduciaries must base decisions on investments and investment courses of action solely on *pecuniary* factors.

PECUNIARY, OR NON-PECUNIARY, THAT IS THE QUESTION

- Pecuniary factors are those expected to have a material effect on risk and/or return of an investment, not its social and environmental impact.

If pecuniary sounds peculiar, just think prudence from purely performance factors.

- The DOL feels that ESG investments promote benefits and goals unrelated to financial performance. “As a result, participants may be offered funds that accept lower returns or higher investment risks in order to pursue ESG objectives. Moreover, these ESG funds may often come with higher fees, because additional investigation and monitoring are necessary to assess an investment from an ESG perspective.”
- The DOL maintains that the focus on pecuniary factors in this final rule will “result in higher returns to plan investors by preventing fiduciaries from selecting investments based on non-pecuniary considerations.”

LOYALTY IS PECUNIARY

- The final rule adopts a general restatement of meeting the statutory standard of loyalty under ERISA section 404(a)(1)(A).
- As minimum requirements, a fiduciary’s duty of loyalty is to act with “complete and undivided loyalty to the beneficiaries,” and prohibits the subordination of participants’ interests to “unrelated objectives and bars them from sacrificing investment return or taking on additional investment risk to promote non-pecuniary goals.





REASONABLE ALTERNATIVES

The final rule requires fiduciaries to consider reasonably available alternatives to meet their prudence duties under ERISA when assessing investments. However, the DOL modified the proposal's text to avoid suggesting in the final rule that fiduciaries must scour the marketplace or look at an infinite number of possible alternatives as part of their evaluation.

DOCUMENTING NON-PECUNIARY ANALYSIS OF INVESTMENTS

Fiduciaries (certainly those who work with us at Hays Financial Group) already document and maintain records about their investment selections. The DOL believes that using non-pecuniary factors to choose among investments merits closer scrutiny. That said, the final rule set forth "required investment analysis and documentation requirements in the rare circumstances when fiduciaries are choosing among truly 'indistinguishable' investments (related to the so-called 'tie breaker rule')."

Tiebreaking

This final rule encourages fiduciaries to break ties using their best judgment on the basis of pecuniary factors alone. "If, after completing an appropriate evaluation, a fiduciary cannot distinguish between alternative investments on the basis of pecuniary factors and the fiduciary chooses one of the investments on the basis of a non-pecuniary factor," the fiduciary must document:

- why pecuniary factors alone did not provide a sufficient basis to select the investment or investment course of action;
- how the selected investment compares to the alternative investments with regard to certain factors listed in the rule; 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.

NON-PECUNIARY QUALIFIED DEFAULT INVESTMENT ALTERNATIVES (QDIA)

The final rule expressly provides that in no circumstances may any investment fund, product, or model portfolio be "added as, or as a component of, a qualified default investment alternative (QDIA) if its investment objectives or goals or its principal investment strategies include, consider, or indicate the use of one or more non-pecuniary factors."

TIMING

- This final rule will be effective 60 days after the date of publication in the Federal Register (the current 404(a)(1) regulation applies until then).
- Plans have until April 30, 2022 to make changes necessary to comply with the requirements related to the selection of QDIAs.

For further reading, see the DOL's final rule [here](#).



If you have questions on this rule and its implications, please reach out to hfg@hayscompanies.com.

