Harvard Law School Forum on Corporate Governance

The Department of Labor's ESG-less Final ESG Rule

Posted by Joseph Lifsics, Mayer Brown LLP, on Tuesday, November 24, 2020

Editor's note: Joseph Lifsics is an associate at Mayer Brown LLP. This post is based on a Mayer Brown memorandum by Mr. Lifsics and Lennine Occhino. Related research from the Program on Corporate Governance includes The Illusory Promise of Stakeholder Governance by Lucian A. Bebchuk and Roberto Tallarita (discussed on the Forum here); Reconciling Fiduciary Duty and Social Conscience: The Law and Economics of ESG Investing by a Trustee by Max M. Schanzenbach and Robert H. Sitkoff (discussed on the Forum here); Companies Should Maximize Shareholder Welfare Not Market Value by Oliver Hart and Luigi Zingales (discussed on the Forum here).

On October 30, 2020, the U.S. Department of Labor ("DOL") released its final regulation ("Final Rule") relating to a fiduciary's consideration of environmental, social and governance ("ESG") factors when making investment decisions for plans subject to the Employee Retirement Income Security Act of 1974, as amended ("ERISA"). In response to the proposed rule (the "Proposal"), the DOL received several thousand comments, the vast majority of which opposed the new rule. Many plan sponsors and investment professionals voiced objection to the Proposal's antipathy towards the consideration of ESG factors. In the Final Rule, the DOL generally softened its stance toward the consideration of *economic* ESG factors, but retained its opposition to the consideration of non-pecuniary ESG or other non-pecuniary factors.

Comparing Investment Options

The Proposal modified the longstanding "investment duties" ERISA regulations describing a fiduciary's duties of prudence and loyalty under Section 404 of ERISA by adding that the fiduciary must specifically compare how the relevant investment compares to other similar investments. Some comments to the Proposal wondered whether fiduciaries would be required to "scour the market" and analyze each comparable investment option. Other comments objected on the basis that some investment opportunities may be so unique or time-sensitive that comparing the opportunity against alternatives would not be possible or practical. In response, the Final Rule requires that a fiduciary must compare an investment opportunity with the opportunity for gain associated with *reasonably available* investment alternatives with similar risks.

Pecuniary vs. Non-Pecuniary Considerations

Perhaps the biggest change from the Proposal is that the Final Rule removes all explicit references to ESG. The DOL explained that the term lacks a precise definition and its use in the Proposal conflated each individual "E" "S," and "G" factor. Instead, the Final Rule requires a fiduciary to base its investment decisions solely on pecuniary factors and not subordinate the interests of participants and their beneficiaries to any non-pecuniary objectives. The DOL acknowledged that ESG factors may be compatible with a purely financial analysis of an investment option or strategy. Under the Final Rule, a fiduciary can appropriately incorporate pecuniary ESG factors into its decision-making process without having to undergo additional documentation requirements, as the Proposal required in certain instances. Conversely, a fiduciary may not consider non-pecuniary factors when choosing an investment option or strategy, regardless of whether the factor relates to ESG, if the investment decision can be made based on pecuniary factors alone.

A "pecuniary factor" is defined as a factor that a fiduciary prudently determines will have a material effect on the risk or return of an investment based on appropriate investment horizons consistent with the plan's investment objectives and funding policies. Although not in the express regulatory text, the DOL notes in the preamble that it believes that it would be consistent with ERISA for a fiduciary to consider factors that present "economic risks or opportunities that qualified investment professionals would treat as material economic considerations under generally accepted investment theories."

Several comments argued that fiduciaries of multiemployer pension plans have unique concerns that they should be able to consider when making investment decisions. They argued that such plans should be able to consider investments that could lead to the benefit of plan participants, such as investments that could lead to increased employment opportunities. The DOL rejected this reasoning, stating that ERISA requires that a plan be operated for the benefit of participants and beneficiaries, in their capacity as such and not in their capacity as union members or employees. The DOL expressed its most vehement disagreement with comments which argued that plan investments should focus on society or economy-wide issues. In response, the DOL Secretary penned an op-ed stating that plan fiduciaries are not tasked "with solving the world's problems" but must focus exclusively on providing retirement benefits to plan participants.

The Final Rule continues to express skepticism towards ESG ratings systems and indexes, since a rating or inclusion on an index may be based on a variety of ESG factors, including non-pecuniary ESG considerations. The preamble to the Final Rule provides that prior to relying on any ESG ratings system, a plan fiduciary must determine the methodology, weighting, data source and assumptions used in such a system. When considering an investment in an ESG-indexed fund, the fiduciary should analyze the index's objective, maintenance, benchmarks and construction to understand whether and how the ESG factors used are pecuniary. Plan fiduciaries should also be wary of funds that contain disclosures that the fund may forego investment opportunities and accept different investment risks in order to pursue ESG objectives.

The Use of Non-Pecuniary Factors as a "Tie-Breaker"

The Proposal allowed plan fiduciaries to use non-pecuniary factors as a theoretical "tie-breaker" when deciding between multiple investment options only if they were economically indistinguishable. Some commenters thought this standard was inappropriately rigid and implied that the tie-breaker exception was unavailable unless the relevant investment options were perfectly identical with respect to each and every risk metric. The Final Rule's wording is slightly more permissive and allows a fiduciary to use non-pecuniary factors to make an investment decision when it is unable to distinguish between the options based on pecuniary factors alone.

When using non-pecuniary factors to distinguish between economically similar investment options, the fiduciary must document: (1) why pecuniary factors were an insufficient basis on which to make the investment decision; (2) a comparison of the investment options and (3) a description of how the non-pecuniary factors used are consistent with the financial interests of participants and beneficiaries under the plan. It is important to note that even when used as a tie-breaker, the use of non-pecuniary factors is still subject to the duty of loyalty. Accordingly, the Final Rule would allow a fiduciary to break a tie between multiple investments based on the investment leading to job opportunities for plan participants or because it would respond to participant demand for ESG-based investments. However, the fiduciary would always be prohibited from choosing an investment based on personal policy preferences, even where investments are economically similar.

Individual Account Plans

The Final Rule does away with the Proposal's requirement that a fiduciary for an individual account plan (e.g., a 401(k) plan) document its compliance with appropriate standards if it selects an investment option that contains ESG parameters in the investment mandate. No documentation requirement is required as long as the selection is made based on pecuniary factors, even if an investment option also happens to support non-pecuniary goals. In addition, the Proposal did not permit the use of non-pecuniary ESG factors for individual account plans, even to distinguish between identical investment options. The DOL reasoned that such an allowance was unnecessary given that individual account plan platforms are intended to consist of a variety of investment options. The Final Rule continues to express doubt as to whether a tie-breaker is really relevant in the individual account plan context, but ultimately allows for non-pecuniary factors to be used as a tie-breaker for such plans.

However, the Final Rule prohibits the selection of any investment option as a qualified default investment alternative[1] ("QDIA") if its investment objectives, goals or principal investment strategies include, consider or indicate the use of non-pecuniary factors, even if its selection as the plan's QDIA would be based solely on pecuniary considerations. This would include funds that exclude investments from certain sectors (e.g., weapons, gaming or tobacco) in their objectives or principal strategies if the investments are excluded for non-pecuniary reasons. The DOL reasoned that a heightened standard is appropriate for QDIAs since they tend to be used by plan participants with less sophistication and investment experience. The Final Rule notes that an investment option that includes ESG factors could still be selected as a QDIA, provided that such ESG factors are based purely on financial considerations.

Effective Date

The majority of the Final Rule will take effect on January 12, 2021 (60 days after its publication in the Federal Register) and apply to investment decisions made after such date. This includes new investments, but also decisions by plan fiduciaries as to whether to retain plan investments. However, fiduciaries need not divest of investments that would have been prohibited by the Final Rule when originally selected if such divestment is not prudent at the relevant time. Plans will have until April 30, 2022 to take action to remove any QDIAs that consider non-pecuniary factors in their investment objectives, goals or principal investment strategies. While a Biden administration could propose new rulemaking to blunt the effect of the Final Rule, this is not a

[1] QDIAs are default investment options for participants who have not made their own investment choice. ERISA regulations provide a "safe harbor" for a fiduciary's selection of the investment option if certain conditions are met.

certainty. As we saw with the Trump administration's response to the "Fiduciary Rule," overturning a final regulation that has already been subject to a notice and comment period is not quite as simple as overturning sub-regulatory guidance that the DOL issues in interpretative bulletins or field assistance bulletins. Accordingly, plan fiduciaries should ensure their investment decisions and practices comply with the Final Rule when it takes effect.