EMPLOYEE BENEFITS AND EXECUTIVE COMPENSATION

DEPARTMENT OF LABOR FINALIZES REGULATIONS ON ERISA PLAN INVESTMENTS IN "ESG" (SOCIALLY CONSCIOUS) FUNDS

On October 30, 2020, the Department of Labor issued final regulations restricting ERISA plans from making investment decisions based on "non-pecuniary" factors. Most notably, the regulations are designed to prevent plans from making use of funds and investment strategies promoting "environmental, social and governance" ("ESG") considerations unless specified conditions are met (including a requirement that such an investment is also appropriate when only economic considerations are taken into account). The final regulations retreat somewhat from the aggressive opposition that the proposed regulations issued this summer had expressed towards ESG investing and remove explicit references to ESG factors from the text of the regulations themselves. However, the preamble makes it clear that the Department's purpose in issuing the regulation remains the curtailment of ESG-oriented decision making by benefit plans, unless an ESG factor is also a "pecuniary" factor properly taken into account in an economic analysis of the investment.

For decades, the Department of Labor had consistently maintained that a benefit plan could not sacrifice returns or take on increased risk in order to pursue goals other than the economic best interests of the plan as an investor (and by extension, the economic best interests of plan participants). However, the Department had agreed that non-economic factors could be used as a tiebreaker between two economically comparable investments. For example, if two companies offered economically equal opportunities, a fiduciary could choose the company most aligned with a desired environmental, social or governance goal. The Department had also conceded that in some cases, ESG factors can be economic factors. For example, a prudent investor likely would investigate before investing in a company facing liability for an environmental catastrophe, in order to determine whether the company's revenues would support the financial liability and whether the company's prospects would be threatened by bad publicity associated with the disaster.

In the proposed regulations, however, the Department expressed extreme skepticism that two investments truly would be so economically equivalent as to justify the "tiebreaker" approach. The Department also asserted that ESG investment strategies are generally economically inferior to other strategies, prohibited the use of ESG funds as "default" investment options for participants who fail to make investment selections, and required plan fiduciaries seeking to include ESG funds in their plans to adhere to enhanced analytical and documentation requirements.

In keeping with the Department's long-standing insistence that plans must act always and only in the plan's economic best interests, statistics indicate that very few benefit plans utilize ESG-themed investments as such.

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However, the financial industry has been more vocal in recent years about the roles played by environmental and social impacts from a company's business and the quality of its organizational governance in the analysis of the merits of the investment from an economic perspective. Unsurprisingly, in light of this general consensus in favor of giving appropriate economic weight to ESG factors, comments on the proposed regulations from the financial industry overwhelmingly rejected the Department's assertions that ESG investing was generally not a sound economic strategy. Plan sponsors, along with financial and benefits professionals, also raised concerns about the burdens and litigation risk likely to be generated by the proposed regulations' requirements of enhanced analysis and documentation, noting the lack of any evidence that current benefit plan practices are problematic. The comments also objected to the unusually brief 30-day comment period.

In response to the comments, the Department retreated somewhat from its original proposal. The final regulations provide for the following:

- A fiduciary must act prudently, and solely in the interests of participants and beneficiaries.
- In making an investment decision, the fiduciary should take into account relevant factors, including the role the investment will play in the plan's portfolio. The fiduciary must conclude that the investment or investment course of action is reasonably designed, taking into account the risk of loss and opportunity for gain, to further the purposes of the plan (i.e., the provision of benefits to participants and payment of reasonable plan expenses), and should consider the diversification of the plan (or the relevant part of the plan's portfolio, as applicable), the liquidity and current return of the portfolio relative to anticipated cash flow needs, and the portfolio's projected return relative to the plan's funding objectives.
- The fiduciary must base investment decisions solely on pecuniary factors (subject to the "tiebreaker" exception, if applicable). The fiduciary cannot sacrifice investment return or take on additional investment risk in the pursuit of other, non-pecuniary goals. Each pecuniary factor should be appropriately weighted based on its anticipated impact on an investment's likely risk and return.
- If in fact a fiduciary concludes that two investments cannot be distinguished on the basis of pecuniary factors alone, and wants to use a non-pecuniary factor as a tiebreaker, the fiduciary must document why it could not make a decision based solely on pecuniary factors, how the selected investment compares to alternatives based on the usual pecuniary analysis, and how the tiebreaking, non-pecuniary factors are consistent with the interests of the participants and beneficiaries in their retirement income or financial benefits under the plan.
- The fiduciary investment analysis required by the regulations applies to the selection of designated investment alternatives for participant-directed defined contribution plans, although not to self-directed brokerage accounts and similar arrangements that give participants access to a wide range of investments beyond those specifically designated under the plan.[1] In terms of the designated

[1] The Department reiterated in the preamble its comments made in prior guidance that self-directed brokerage accounts and similar arrangements remain subject to ERISA's general fiduciary standards, with plan fiduciaries required to oversee the cost

investment option menu, a fiduciary can include a fund with non-pecuniary goals as part of that menu, if the prudence and economic analysis requirements outlined above are met. The preamble even acknowledges that responding to participant demand in order to increase plan participation and retirement savings may be appropriate, so long as the fund meets the requirements to be prudent and to be a justified choice on the basis of pecuniary factors. However, the Department emphasized that fiduciaries must take great care to be sure that the fund will not sacrifice returns or increase risk in pursuit of non-pecuniary goals. In addition, the regulations state that a fund cannot be used as a qualified default investment alternative "if its investment objectives or goals or its principal investment strategies include, consider, or indicate the use of one or more non-pecuniary factors."

The regulations are scheduled to take effect 60 days from publication in the Federal Register and will apply to all investments made and investment courses of action taken after that date. However, plans do not need to change a qualified default investment alternative to comply with the new regulations prior to April 30, 2022.

With respect to any existing investment, whether or not serving as a qualified default investment alternative, fiduciaries should bear in mind that the regulatory requirements will apply to an ongoing decision to keep rather than divest from an investment, since that is an "investment course of action." In other words, the regulations do NOT give an exemption to existing investments; instead, the Department has drafted the regulation to avoid the need to divest an otherwise currently prudent investment that meets the pecuniary-factors analysis simply because it may have been initially chosen in a manner that would be problematic under the new rules. Plan fiduciaries should review their current investment portfolios and discuss any concerns with their investment consultants and fund managers, as appropriate.

As always, please feel free to contact a member of the Employee Benefits & Executive Compensation group at 585.232.6500, 716.853.1616, or visit www.hselaw.com for more information about the items discussed in this newsletter, or for assistance in other matters.

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and quality of the arrangement, and with transactions under the arrangements required to comply with ERISA. The Department remarked, "Although the Department has determined that the establishment of regulatory standards governing such arrangements is beyond the scope of this particular regulation, this issue could be addressed in future rulemaking or sub-regulatory guidance if necessary. The Department, therefore, is available as necessary to engage in discussions with interested parties to help determine how best to assure compliance with these duties in a practical and cost effective manner."