

Clients & Friends Memo

Department of Labor Finalizes Rule Adopting Amendments to the “Investment Duties” Regulation

November 18, 2020

On October 30, 2020, the U.S. Department of Labor (“DOL”) published its final rule (“Final Rule”) adopting amendments to its longstanding “investment duties” regulation under the Employee Retirement Income Security Act of 1974, as amended (“ERISA”) at 29 C.F.R. Section 2550.404a-1 (“Section 404a-1 Regulation”). The Final Rule mandates, as a general matter, that plan fiduciaries must evaluate and select investments and investment courses of action based solely on the financial considerations applicable to the investment or investment course of action, and may not subordinate return or increase risks to promote non-pecuniary objectives.

Background

ERISA sets forth the duties applicable to plan fiduciaries when managing plan investments. Section 404 of ERISA contains the fiduciary provisions relating to prudence and diversification, as well as the requirement that fiduciaries act solely in the interests of plan participants and beneficiaries for the exclusive purpose of paying benefits and defraying reasonable expenses of administering the plan. With regard to the latter, courts have interpreted this standard as requiring fiduciaries to act with complete and undivided loyalty to plan participants and beneficiaries.

The DOL initiated this regulatory effort to amend the Section 404a-1 Regulation due to perceived heightened concerns raised by environmental, social and corporate governance (“ESG”) investing. In June 2020, the DOL issued a proposed regulation that would amend the Section 404a-1 Regulation to address the concerns regarding the use of ESG and related “non-pecuniary” considerations. The DOL additionally sought to provide clarity and certainty regarding the application of ERISA’s fiduciary duties to the analysis of the extent to which a fiduciary may consider non-pecuniary issues in connection with such investments and investment courses of action. The DOL received more than 8,700 comments and petitions relating to the proposed rule, many of which raised concerns about the DOL’s approach in any final regulation (including a belief that the existing Section 404a-1 Regulation provided sufficient guidance and was sufficient to form a basis for enforcement actions against fiduciaries who breach their duties under ERISA in connection with ESG investments).

The Final Rule

In the Final Rule, the DOL makes several significant changes to the Section 404a-1 Regulation. This Final Rule is intended by the DOL to provide a regulatory structure to aid “fiduciaries in navigating these ESG investment trends and to separate the legitimate use of risk-return factors from inappropriate investments that sacrifice investment return, increase costs, or assume additional investment risk to promote non-pecuniary benefits or objectives.”

As an initial matter, one important change made to the proposed regulation in the Final Rule is the DOL’s removal of express references to ESG, despite the fact that the DOL’s self-described impetus for the rule-making effort involved concerns associated with ESG investing. Indeed, much of the preamble to both the proposed regulation and the Final Rule discuss ESG-related issues (and refer to ESG by name). According to the DOL, this change was made in response to, and recognition of, historical inconsistency and evolution regarding the terminology, meaning, and usage associated with ESG and similar investment considerations.

Notably, the Final Rule includes the following (what the DOL characterizes in the release as “major”) amendments to the Section 404(a)(1) Regulation:

- The Final Rule includes language mandating that ERISA fiduciaries must evaluate investments and investment courses of action based solely on pecuniary factors, except in the limited circumstances described below. “Pecuniary factor” is defined in the Final Rule to mean 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 a plan’s investment objectives and funding policy.
- The Final Rule contains a provision expressly stating that the duty of loyalty in Section 404 of ERISA prohibits plan fiduciaries from subordinating the interests of the plan participants and beneficiaries to other objectives and sacrificing returns or taking on additional investment risk to promote non-pecuniary interests.
- The Final Rule adds new language providing that a fiduciary, when considering an investment or investment course of action, must compare such investment or course of action with the opportunity for gain or other return associated with reasonably available alternatives with similar risks.

Note: The DOL indicated that the fiduciary is only required to compare alternatives that are reasonably available under the circumstances. The DOL noted that this new provision does not require a fiduciary to “scour the market” or consider every possible alternative, and also allows for the possibility that the characteristics of a given investment may be sufficiently rare such that a fiduciary could prudently determine (and document) that there were no reasonably available alternatives.

The Final Rule outlines the requisite analysis and documentation for circumstances when a fiduciary is choosing between or among investments or investment courses of action where the fiduciary cannot distinguish between or among such options based on pecuniary factors alone.

Note: This provides a limited exception to the requirement that all investments be made and investment courses of action taken based on pecuniary factors. The so-called “tie breaker” test permits a fiduciary to base an investment decision on non-pecuniary factors if the fiduciary is unable to distinguish between or among investments on the basis of pecuniary factors alone, so long as the fiduciary documents (1) why pecuniary factors were insufficient, (2) how the chosen investment compares to the other investments with regard to diversification, liquidity and current return relative to the plan’s anticipated cash flow requirements, and the projected return relative to the plan’s funding objectives, and (3) how the relevant non-pecuniary factors are consistent with the interests of the plan participants and beneficiaries in their retirement income or benefits. The DOL reiterated that when a fiduciary makes an investment decision based on non-pecuniary factors to the extent permitted under the Final Rule, it remains subject to ERISA’s duty of loyalty and must act in a manner that is consistent with the interests of the participants and beneficiaries.

The Final Rule provides that the fiduciary duties of prudence and loyalty in Section 404 of ERISA and addressed in the Final Rule apply to the selection or retention of designated investment alternatives for participant-directed defined contribution plans. A fiduciary is not prohibited from considering or including an investment option solely because the option promotes, seeks or supports one or more non-pecuniary goals so long as the fiduciary satisfies its prudence and loyalty obligations under ERISA and the Final Rule (including the requirement to evaluate solely based on pecuniary factors). Importantly, however, the Final Rule prohibits plan fiduciaries from adding any investment alternative as a “qualified default investment alternative” (“QDIA”), as described in the DOL’s regulation at 29 C.F.R. Section 2550.404c-5, or as a component of a QDIA, if such alternative’s investment objectives, goals or principal investment strategies include, consider or indicate the use of one or more non-pecuniary factors.

Effective Date of the Final Rule

The Final Rule shall be effective on January 12, 2021, and applies to all investments and investment courses of action taken after such date. Notwithstanding the foregoing, plans have until April 30, 2022 to make any changes to QDIAs to the extent necessary to comply with the new restriction on QDIAs regarding the usage of non-pecuniary factors.

While the Final Rule will be effective in January, it is unclear whether and to what extent the Biden administration may revisit this regulatory project and provide its own interpretations or make

changes (or whether the Final Rule may be the subject of future court challenges). Fiduciaries should continue to monitor developments in this area.

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If you have any questions, please feel free to contact any of the following Cadwalader attorneys.

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