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ERISA Considerations in ESG Investing

Chapter 20. ERISA Considerations in ESG Investing

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.10 ESG INVESTING OVERVIEW

.10.10 ESG Investing Basics —

Risks and Opportunities Entailed in ESG Investing: Investment decisions that take into account environmental, social, and/or governance (ESG) risks will likely grow in prominence and prevalence over the coming years. This means that, with the increased attention given to ESG in today's markets, fiduciaries of private and public retirement plans are appreciating both the investment opportunities, and fiduciary duty risks, that lie ahead.

Description of ESG Strategies: ESG investing can broadly be described as a strategy to incorporate ESG factors into the investment process. These factors may be viewed as a source of material investment risk or return on investment. ESG may also be pursued in order to further non-investment performance reasons, which has been the historical approach to ESG investments. It is no longer the case that ESG investing consists primarily of either screening out, or divesting, of certain issuers/sectors because they don't meet some moral or other non-economic test. Instead, ESG is much more driven by data linking one or more ESG factors and investment performance.

ESG Evolution: ESG as a hard-nosed, data-driven investment strategy is of somewhat recent vintage. Historically, institutional investors targeted “sin stocks," such as tobacco and alcohol, primarily out of moral outrage. This practice can be referred to “socially responsible investing” and has spurred values-based mutual funds. Divestment, a form of exclusionary investing, has also long been a practice associated with ESG. Perhaps the most famous example of divestment was during the 1980s when many investors sold positions in South African companies during apartheid.

Interest in ESG strategies and products has grown considerably because there is greater understanding of how various E, S, and G issues (see below) can affect investment performance.

.10.20 Terminology —

Admittedly, there is fairly widespread confusion over what ESG means and which factors technically fall under the ESG umbrella. Under some definitions, upwards of 40 different environmental, social, and governance issues can be considered "ESG factors." Part of any fiduciary's consideration and implementation of ESG strategies is a clear understanding of the terminology. The following definitions may help clarify that understanding:

- **Environmental (E) factors.** Issues or facts related to the natural environment, such as climate change, carbon emissions, waste management, recycling, energy, biodiversity, pollution, and conservation.

- **Social (S) factors.** Issues or facts related to human relations of an issuer (e.g., a corporation or country), such as employee relations, community relations, board diversity, human rights, demography, food security, poverty/inequality, child labor, health, and safety.

- **Governance (G) factors.** Issues or facts related to the governance of an issuer, such as executive compensation, board structure, shareholder rights, bribery, corruption, and cybersecurity.

Many also wonder how "ESG investing" differs from "impact investing," "socially responsible investing," and "sustainable investing." Ultimately, these terms and approaches differ by the degree to which they emphasize E, S, and/or G factors and the rationale for why those factors are included.

- **Impact investing.** The selection of investments in respect of an ESG factor where the primary purpose is for non-investment performance reasons, such as the promotion of an ESG public policy, and a secondary purpose is to enhance portfolio return or reduce portfolio risk.

- **Responsible investing.** The selection of investments where: (1) the primary purpose is for non-investment performance reasons, namely the promotion of a governance-related (G) factor (see above), and a secondary purpose is to enhance portfolio return or reduce portfolio risk; or (2) the exclusive purpose is for one or more non-investment performance reasons, namely the promotion of a G factor.

- **Socially responsible investing.** The selection of investments where: (1) the primary purpose is for non-investment performance reasons, namely the promotion of a social-related (S) factor (see above), and a secondary purpose is to enhance portfolio return or reduce portfolio risk; or (2) the exclusive purpose is for one or more non-investment performance reasons, namely the promotion of an S factor.

- **Sustainable investing.** The selection of investments where: (1) the primary purpose is for non-investment performance reasons, namely the promotion of an environmental-related (E) factor (see above), and a secondary purpose is to enhance portfolio return or reduce portfolio risk; or (2) the exclusive purpose is for one or more non-investment performance reasons, namely the promotion of an E factor.

- **Thematic investing.** The utilization of negative screening, positive screening, integration, and/or engagement (as defined below) to invest in issuers that share a common ESG purpose, industry, or product.

ESG investing. Can broadly be defined to include each of these strategies and approaches, as further refined below.

Additional Resources: Gerstein, George Michael: Investing According to Environmental, Social, and Governance Mandates, Compensation Planning Journal (BNA) (Apr. 5, 2019); Commentary on 2018 DOL Guidance on Socially Responsible Investing; Climate Change Defines the Fiduciary, Pension & Benefits Daily (BNA) (Oct. 3, 2017); In Focus: ESG Investing Principles Under ERISA; Practical Guidance: ESG Social Considerations; ESG Risk

Management for Financial Institutions (Annotated)

.20 ESG APPROACHES

.20.10 Major ESG Approaches —

With an understanding of key ESG terminology, the fiduciary can proceed to consider the additional ways that ESG factors can become part of an investment process. The major ESG approaches include:

- **Exclusionary (Negative) Screening.** Avoiding the purchase of prospective investments, or divesting from existing investments, on the basis of such investments not meeting a designated ESG standard, rating, or requirement where: (1) the exclusive purpose is to enhance portfolio return or reduce portfolio risk; (2) the primary purpose is for non-investment performance reasons, such as the promotion of an ESG public policy, and a secondary purpose is to enhance portfolio return or reduce portfolio risk; or (3) the exclusive purpose is for one or more non-investment performance reasons, such as the promotion of an ESG public policy.

- **Positive Screening.** Selecting investments on the basis of meeting a designated ESG standard, rating, or requirement where: (1) the exclusive purpose is to enhance portfolio return or reduce portfolio risk; (2) the primary purpose is for non-investment performance reasons, such as the promotion of an ESG public policy, and a secondary purpose is to enhance portfolio return or reduce portfolio risk; or (3) the exclusive purpose is for one or more non-investment performance reasons, such as the promotion of an ESG public policy.

- **Integration.** Incorporating ESG-related data and/or information in respect of an ESG factor into the usual process when making an investment decision where such data or information is material to investment performance and where the exclusive purpose is to enhance portfolio return or reduce portfolio risk.

- **Engagement.** Exercising one or more rights of a holder of interests in an issuer, such as proxy voting, introducing resolutions, or participating in formal or informal meetings with the issuer board, in respect of an ESG factor where: (1) the exclusive purpose is to enhance portfolio return or reduce portfolio risk; (2) the primary purpose is for non-investment performance reasons, such as the promotion of an ESG policy, and a secondary purpose is to enhance portfolio return or reduce portfolio risk; or (3) the exclusive purpose is for one or more non-investment performance reasons, such as the promotion of an ESG policy.

.20.20 Growth in ESG Investing —

Interest in and development of investment products, services, and data related to ESG has grown over the past decade or so on a seemingly exponential basis. This holds true across investor type, asset class, and country (to various degrees). Both the size of the asset pool incorporating ESG, and the percentage of investors incorporating ESG factors into investment decisions, continue to increase.[1]

[1] See, e.g. US SIF Foundation, Sustainable and Impact Investing—Overview; Axel Peirron, ESG Data: Mainstream Consumption, Bigger Spending, Opimas (Jan. 9, 2019); 2020 ESG Survey Callan Institute.

.20.30 Role of Fiduciaries in ESG Investing —

Fiduciaries of plans subject to ERISA should consider their fiduciary duties set forth in ERISA §404, and applicable Department of Labor (DOL) guidance on the interplay of fiduciary duties and ESG investing when taking ESG issues into account. Similarly, fiduciaries of governmental plans should evaluate their fiduciary duties and any specific ESG-related restrictions and requirements set forth in the state constitution and applicable statutes and/or regulations. While the discussion that follows is focused on ERISA, governmental plan fiduciaries will also benefit from these insights.

> ***Practice Tip:*** Fiduciaries should be mindful of how they can satisfy their duties of loyalty, prudence, and diversification when taking ESG factors into account in investment decisions. It is also important for fiduciaries to confirm that ESG investing doesn't violate plan documents, such as an Investment Policy Statement (IPS) or the plan's proxy voting policy, if any. For more on fiduciary duties, see below.

.30 FIDUCIARY RESPONSIBILITIES IN ESG INVESTING

.30.10 Fiduciary Investment Responsibilities —

The crux of fiduciary responsibility under ERISA, in pertinent part, is the duty to:

- act solely in the interest of participants and beneficiaries in their pursuit of retirement income/promised benefits;[2]
- engage in prudent decision-making, including a thoughtful and informed process when selecting and monitoring investments and investment managers;[3]
- select investments that are appropriate for the plan, taking into account the benefits of portfolio diversification based on factors that materially affect risk and reward of the investment consistent with the plan's funding and investment objectives;[4] and
- comply with the governing documents of the plan.[5]

[2] ERISA § 404(a)(1)(A).
[3] ERISA § 404(a)(1)(B).
[4] ERISA § 404(a)(1)(B); 29 C.F.R. § 2550.404a-1. This prong reinforces the importance of a prudent process while recognizing the importance of diversification, a distinct fiduciary duty set forth in ERISA § 404(a)(1)(C).
[5] ERISA § 404(a)(1)(D).

As discussed above, a fiduciary incorporating ESG factors may do so by a combination of investment approaches (e.g., positive and negative screens, engagement, etc.). Each of these activities must be performed in accordance with the fiduciary duties outlined above.

> **Practice Tip:** Whether and to what extent to incorporate one or more ESG factors into the investment process is an important decision. A fiduciary may wish to consider: (1) whether and how the plan will address ESG broadly or instead focus on discrete E, S, and/or G factors; (2) whether the plan will screen for best-in-class ESG investments/issuers, divest from “bad actors,” select an investment for other than investment performance reasons, and/or engage companies; (3) whether and how to address ESG in the plan's IPS or have ESG-specific policies; and (4) whether and how to select (and monitor) third-party investment managers based on their ability to incorporate ESG factors into their investment process.

.30.20 Addressing ESG in Investment Policy Statements —

An IPS may be considered part of the governing documents of a plan, particularly under ERISA. Investment managers, and other fiduciaries, therefore, should comply with the IPS unless doing so would violate their fiduciary obligations. Moreover, merely determining the terms of an IPS is considered a fiduciary decision under ERISA.[6]

Items to consider include:

[6] 29 C.F.R. § 2509.2016-01.

- **Scope.** How does the plan define "ESG"? Is it focused on all E, S, and G factors or a subset of them?
- **Test and analysis.** Is the plan only focused on ESG factors that are material to portfolio performance by reason of their risk and return characteristics or is ESG sought for non-investment performance reasons? Will scenario analysis be used?
- **Asset class.** Should all asset classes account for ESG factors? Institutional investors aren't only incorporating ESG into equities, but also in fixed income (e.g., sustainable and green bonds), alternatives (both private equity and hedge funds, for example, offer ESG strategies, though to different degrees), and foreign exchange.
- **Passive vs. active.** Does the plan want to employ passive (e.g., a themed index) and/or active strategies to incorporate ESG factors?
- **ESG approach.** Will positive or negative screening be used? Engagement, etc.?
- **Benchmark.** How will investments and investment managers be evaluated? Will the benchmark be ESG-specific or will a more traditional benchmark be optimized?[7]
    - **Investment managers.** Will the plan condition appointment of the investment manager on the investment manager being a United Nations Principles for Responsible Investment (PRI) signatory? Will the plan require ESG-specific reporting?[8]

[7] The selection of an appropriate benchmark is an important fiduciary decision. ESG-specific indices continue to come to market, potentially alleviating some of the initial concerns fiduciaries had when first incorporating ESG products into the plan.

[8] *See*, Retirement Benefits Checklist—Considerations for Fiduciaries When Investing Based on Environmental, Social, and Governance (ESG) Factors, below.

.30.30 Selecting and Monitoring Investment Managers —

A fiduciary, such as a plan investment committee, may not feel that they have the requisite experience and expertise to incorporate ESG factors into the investment process. The outsourcing of ESG responsibility has grown; investment managers now routinely respond to ESG-related questions in the request for proposal process.[9]

[9] The sheer number of ESG-related questions is reported to have increased quite significantly in RFPs, including the level of detail sought by plans. This has led to challenges in time and resources to respond to these questions in a thoughtful and thorough manner.

Practice Tip: PRI and the Financial Stability Board's Task Force on Climate-related Financial Disclosures each offer useful frameworks for both asset owners and managers to address myriad ESG-related issues. These frameworks, for example, can assist with engaging company boards to address ESG risks, selecting service providers/products, devising and implementing investment policy statements, and incorporating E, S, and/or G factors on an asset class basis.[10]

[10] PRI, A Practical Guide to ESG Integration for Equity Investing (Sept. 5, 2016); Financial

Stability Task Force on Climate-related Financial Disclosures.

ERISA requires oversight of investment managers. The plan investment committee, for example, "must reasonably conclude that the investment manager's practices in selecting investments are consistent with" the DOL guidance on ESG investments.[11] The committee may seek reporting from its investment managers on which ESG tools the manager uses, how ESG factors influence buy/sell decisions, and to what extent engagement influences a decision to hold or sell a position. In addition to written reports, a committee may wish to discuss ESG incorporation when it meets with the plan's investment managers.[12]

[11] 29 C.F.R. § 2509.2015-01.

[12] See e.g. A Practical Guide to ESG Integration for Equity Investing (Sept. 5, 2016).

.30.40 Prudent Process and Analysis —

Under ERISA, the duty of prudence entails, as part of a methodical and documented process, a fiduciary giving "appropriate consideration" to facts and circumstances that are relevant to a proposed investment, "including the role the investment…plays in that portion of the plan's investment portfolio with respect to which the fiduciary has investment duties…."[13] "Appropriate consideration" in this context means a determination that the proposed investment is reasonably designed, as part of the portfolio, to further the purposes of the plan, taking into account the risk/return characteristics of the investment based on the consideration of the following factors:

[13] 29 C.F.R. § 2550.404a-1.

- the composition of the portfolio with regard to diversification;
- the liquidity and current return of the portfolio relative to the plan's anticipated cash flow requirements; and
- the projected return of the portfolio relative to the plan's funding objectives.[14]

[14] 29 C.F.R. § 2550.404a-1.

> ***Practice Tip:*** Fiduciaries evaluating ESG investment funds should examine and address, as part of a prudent process, whether these funds: (1) are more expensive than comparable non-ESG funds; (2) lack track records; and/or (3) lack significant assets under management. Moreover, fiduciaries making portfolio changes to account for ESG risks should be mindful of diversification issues, which are an important, but often overlooked, consideration.

There are a number of services available to fiduciaries that score and rank public companies, investment funds, and investment manager strategies based on ESG metrics. Each of the available services uses different inputs and weightings, creating issues of comparability. Some of the data used to create the ratings derive from data voluntarily disclosed by a public company.

> ***Practice Tip:*** Fiduciaries should consider the utility and limitations of data providers.

.40 DOL GUIDANCE ON ESG INVESTING

.40.10 Final Investment Duties Rule —

In November 2020, the DOL finalized amendments to the investment duties rule governing fiduciaries subject to ERISA.[15] The rule amendments were aimed at ERISA fiduciaries that utilize products and strategies that incorporate ESG factors.

[15] 29 C.F.R. § 2550.404a-1.

Practice Tip: Though the DOL opted not to let the final rule get bogged down in the ESG-lexicon quagmire by removing all express references to 'ESG,' the final rule clearly and directly applies to fiduciaries that consider ESG factors when investing on behalf of ERISA plans and funds that hold "plan assets." Indeed, all ERISA fiduciaries that make investment decisions (including the selection of investment funds for participant-directed plan lineups), regardless of whether ESG is even implicated, should review this rule carefully.

The rule went into effect on Jan. 12, 2021; plans have until April 30, 2022, to make any rule-driven changes to their "qualified default investment alternatives" (QDIAs), within the meaning of 29 C.F.R. § 2250.404c-5 The rule contemplates a grandfathering mechanism, which will be highly fact-specific.[16]

[16] In a footnote to the preamble of the rule, the DOL stated, "[t]he Department notes that it may be that a fiduciary could prudently determine that the expected return balanced against the costs and risks of loss associated with divesting an investment made before the effective date of the rule are such that continuing to hold that investment would be appropriate even if the fiduciary as part of its monitoring process determined that the investment, or aspects of the decision-making process, does not comply with the final rule." 85 Fed. Reg. 72869 (Nov. 13, 2020).

On March 10, 2021, the DOL announced that it will not enforce the rule nor pursue enforcement actions against plan fiduciaries who fail to comply with it as to investments, including a QDIA. Citing reports of investor confusion over the rule, the DOL said it will revisit the rule, but cautioned that it can still enforce any statutory requirement under ERISA, including the statutory duties of prudence and loyalty in ERISA Section 404.[17]

[17] U.S. DEPARTMENT OF LABOR STATEMENT REGARDING ENFORCEMENT OF ITS FINAL RULES ON ESG INVESTMENTS AND PROXY VOTING BY EMPLOYEE BENEFIT PLANS.

The rule builds upon the original investment duties regulation, which provided a safe harbor for fiduciaries in satisfying their duty of prudence under ERISA. Like the original, it compels fiduciaries to give appropriate consideration to numerous factors regarding the composition of the plan portfolio as it relates to diversification, liquidity, and current return of the portfolio relative to the anticipated cash flow needs of the plan, and the projected return of the portfolio relative to the funding objectives of the plan, and the projected return of the portfolio relative to the funding objectives of the plan. Importantly for ERISA § 3(38) investment managers, the rule preserves the aspects of the original regulation that allowed investment managers to rely and act on information provided by the appointing fiduciary in fulfilling these duties with respect to the plan portfolio over which it has discretion.

The rule withdraws DOL Interpretive Bulletin 2015-01 and supersedes "ESG Investment Considerations" in DOL FAB 2018-01.

This rule does not address an ERISA fiduciary's responsibilities with respect to proxy voting and the exercise of other shareholder rights. For more on a separate regulation that addresses those responsibilities, see Proxy Voting by Plan Fiduciaries.

.40.20 Key Considerations —

The rule preserves the essence of the original investment duties regulation (and ERISA) by allowing ERISA fiduciaries considerable leeway in crafting investment portfolios. The DOL thus admitted that, as a general matter, there is total parity between investment strategies and products, whether ESG-related or not. In other words, an ERISA fiduciary may manage plan assets while considering ESG risks and opportunities without violating the rule.

The rule presents five distinct issues worth considering: (1) pecuniary factors; (2) comparing investment alternatives; (3) duty of loyalty; (4) special circumstances/non-pecuniary factors/tie-breakers, and (5) QDIAs.

Pecuniary Factors. Whether investing on behalf of an ERISA-covered defined benefit plan or selecting plan investment options for a participant-directed plan, fiduciaries must consider pecuniary factors only, absent special circumstances (discussed below), when evaluating the risk and return profiles of investments. A "pecuniary factor" is one "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…."[18]

[18] The proposed rule seemingly required that, before an ERISA fiduciary could treat an ESG or other factor as a pecuniary factor, the ESG or other factor would already have had to be determined by other investment professionals as being material to investment performance.

Whether investing on behalf of an ERISA-covered defined benefit plan or selecting plan investment options for a participant-directed plan, fiduciaries must consider pecuniary factors only, absent special circumstances (discussed below), when evaluating the risk and return profiles of investments. A "pecuniary factor" is one "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…."[19] ESG factors may be pecuniary factors under the rule.[20] The requirement that only pecuniary factors be considered is a legal requirement, not a safe harbor.

[19] The proposed rule seemingly required that, before an ERISA fiduciary could treat an ESG or other factor as

[20] For example, "a company's improper disposal of hazardous waste would likely implicate business risks and opportunities, litigation exposure, and regulatory obligations" and that "[d]ysfunctional corporate governance can likewise present pecuniary risk that a qualified investment professional would appropriately consider on a fact-specific basis." 85 Fed. Reg. 72848 (Nov. 13, 2020).

The rule's definition of pecuniary factors is forward-looking in nature, meaning a fiduciary need not know that a factor will materially affect risk/return at the time of the investment. Instead, the fiduciary must be prudent in coming to that conclusion based on the facts and circumstances.

> ***Practice Tip:*** This change by the DOL should give comfort to fiduciaries who are closely tracking the emerging data of various ESG (and other) factors' impact on investment performance. Fiduciaries should take note that the DOL has repeatedly cautioned fiduciaries against disproportionately weighting the materiality of a factor based on existing data.

The DOL opted to avoid defining the slippery concept of materiality. The DOL said in the rule preamble that it "believes that fiduciaries and investment managers are generally familiar with that concept from its use in connection with both ERISA and the federal securities laws."[21] This seemingly allows the concept of pecuniary factors to evolve with market consensus on materiality and ultimately on how other regulators define materiality for these purposes. Yet, the DOL acknowledged that the following may be material, and thus, pecuniary factors under the rule: (1) an investment manager's brand/reputation; (2) proprietary products; and (3) a fund or product's legal regime that confers greater investor protection and/or improved disclosures.

[21] 85 Fed. Reg. 72846 (Nov. 13, 2020).

As with any other evaluation of prospective investments, a fiduciary should first determine that it has sufficient skills and expertise to determine that the ESG (or any other) factor presents economic risks or opportunities that qualified investment professionals would treat as material economic considerations under generally accepted investment theories. If not, the determination should be made by another fiduciary having such expertise and skill.[22] Moreover, the DOL apparently will look for risk controls in place commensurate with the complexity, nature, and size of the investment activity; the implication is that fiduciaries that consider ESG factors should have rigorous controls in place to ensure that they are properly determining factors to be pecuniary factors under the rule.

[22] The DOL indicated that it does not intend the term "generally accepted investment theories" to freeze the evolution of investment theory or practice, but rather "to establish a regulatory guardrail against situations in which plan investment fiduciaries might be inclined to use…policy-based metrics in their assessment of the pecuniary value of an investment or investment plan that are inherently biased toward inappropriate overestimations of the pecuniary value of policy-infused investment criteria." 85 Fed. Reg. 72846 (Nov. 13, 2020).

In the context of ERISA-covered participant-directed plans, the decision as to which funds populate the plan lineup is subject to ERISA's fiduciary duties and this new rule, among others. In the preamble, the DOL addressed whether a fiduciary could select an ESG investment fund, product, or model portfolio based solely on participant request or because of the potential for increased contributions to the plan. In short, these types of considerations are not pecuniary factors and, therefore, the responsible fiduciary may not base its decision to include them without separately determining that the pecuniary reasons for such inclusion satisfy the rule. As discussed below, however, participant requests and the like may be "tie-breakers" in selecting between alternative investment options.

Comparing Investment Alternatives. Under the rule, the fiduciary must compare investments or investment courses of action (e.g., selection of designated investment alternative for participant-directed plans) based on factors "that are expected to result in a material difference among reasonably available alternatives with respect to risk and/or return." This comparison requirement is, therefore, not limitless. Thus, a fiduciary does not need to consider all factors that differentiate investment funds, only ones that are pecuniary. Moreover, fiduciaries are under no obligation to scour the market for the lowest cost investment opportunities, much less select the cheapest available investments.

A fiduciary need not expend considerable resources on searching for investment opportunities or considering an infinite number of investment alternatives. Instead, the fiduciary's duty to evaluate alternative investment opportunities is limited to comparing alternatives that are reasonably available under the circumstances. This means that the rule "allow[s] for the possibility that the characteristics and purposes served by a given investment…may be sufficiently rare that a fiduciary could prudently determine, and document, that there were no other reasonably available alternatives for purposes of this comparison requirement."[23]

[23] 85 Fed. Reg. 72846 (Nov. 13, 2020).

Duty of Loyalty. Fiduciaries are already well aware that ERISA imposes a duty of loyalty, in addition to the prudence requirements discussed above. The rule incorporates this specific fiduciary duty by prohibiting fiduciaries from subordinating the interests of plan participants and beneficiaries in their retirement income to non-pecuniary goals. Though this may seem to be an example of form over function, the DOL opted not to include the duty of loyalty under the rule's general safe harbor characterization, meaning fiduciaries will likely not only be conservative in satisfying the rule's requirements but may also opt for even stronger controls/analysis/documentation than the rule technically requires to ensure they do not run afoul of the loyalty concerns the DOL has expressed in the context of ESG.

Special Circumstances/Non-Pecuniary Factors/Tie-Breakers. Prior DOL guidance provided that if, after an evaluation, alternative investments appear economically indistinguishable, a fiduciary may then, in effect, "break the tie" by relying on a non-pecuniary factor. Commenters argued that the proposal effectively required equivalence between investments. The DOL suggested that they did not mean for investment alternatives to have identical characteristics-- just equivalent roles in the plan's investment portfolio. Commenters argued that indistinguishability in liquid markets is all but impossible and are, in turn, never perfectly correlated.

Under the rule, if a fiduciary is unable to determine which investment is in the best interests of the plan on the basis of pecuniary factors alone, the fiduciary may base the investment decision on non-pecuniary factors, provided the fiduciary documents the following: (1) why pecuniary factors were not sufficient to select the investment; (2) how the investment compares to the alternative investments; and (3) how the chosen non-pecuniary factors are consistent with the interests of the participants and beneficiaries in their retirement income or financial benefits under the plan. This effectively prohibits ERISA fiduciaries from choosing investments with expected reduced returns or enhanced risks in order to secure non-pecuniary benefits.

The third condition is a hemmed-in version of the historical tie-breaker test. Simply, the DOL split the difference from the proposal, which all but eliminated the tie-breaker mechanism, and instead has allowed a tie-breaker but only on the basis of a pecuniary-light factor. Under the rule, a fiduciary no longer appears able to select an investment fund based on the ethos of the plan sponsor, assuming the other conditions of the rule are met. Instead, the non-pecuniary factor must at least have some nexus to participants' and beneficiaries' retirement income or financial benefits. Responding to participant demand in order to increase retirement plan savings may be consistent with the interests of the participants and interests in their retirement income or financial benefits under the plan. In contrast, selecting an investment option that "would bring greater personal accolades to the chief executive officer of the sponsoring employer, or solely on the basis of a fiduciary's personal policy preferences, would not."[24]

[24] 85 Fed. Reg. 72846 (Nov. 13, 2020).

The same standards apply to selecting investment funds, products, and model portfolios for a participant-directed plan lineup. The DOL admonished fiduciaries to "carefully review the prospectus or other investment disclosures for statements regarding ESG investment policies and investment approaches."[25] In particular, fiduciaries should be "cautious in exercising their diligence obligations under ERISA when disclosures, whether in prospectuses or marketing materials, contain references to non-pecuniary factors or collateral benefits in a fund's investment objectives or goals or its principal investment strategies."[26]

[25] 85 Fed. Reg. 72846 (Nov. 13, 2020).
[26] 85 Fed. Reg. 72846 (Nov. 13, 2020).

The DOL envisions that fiduciaries will evaluate fund prospectuses and other disclosures to determine if the fund uses an ESG or sustainability rating system of index. If the fund uses such a rating system or index, the fiduciary, as part of its due diligence, would need to consider whether the rating system or index "evaluates one or more factors that are not financially material to investments." If so, the selection of the fund is a special circumstance, thereby requiring the fiduciary to satisfy the aforementioned heightened requirements

On this point, the DOL indicated that a fiduciary would have to understand how the ratings are actually determined, such as the rating's methodology, weighting, data sources, performance benchmarks, and the underlying assumptions utilized. Moreover, "a fiduciary may not assume that combining [multiple factors] into a single rating, index or score creates an amalgamated factor that is itself pecuniary."[27]

[27] 85 Fed. Reg. 72846 (Nov. 13, 2020).

QDIAs. On QDIAs, DOL stressed that the proposal was never intended to block investment funds, products, or model portfolios that treat ESG factors as pecuniary in nature from being QDIAs. The rule better captures this intent by only prohibiting those QDIAs whose investment objectives, goals, or principal investment strategies include, consider, or indicate, one or more non-pecuniary factors. Crucially, the tie-breaker mechanism is not available when selecting QDIAs. This means that a fund will no longer qualify as a QDIA if its investment objectives, goals, or principal strategies include a non-pecuniary factor, even if including such fund as a QDIA is in response to participants' request or otherwise increase the desirability of the plan to participants.

The DOL claimed fiduciaries can apply the rule to QDIAs easily and objectively, for example, by simply looking at the investment fund's prospectus to determine whether the fund is qualified or disqualified as a QDIA under the rule. The DOL specifically pointed to Form N-1A to ascertain whether non-pecuniary considerations form a material part of a fund's investment objectives or principal strategies. The DOL is under the impression that disclosures for other types of investment vehicles, such as collective investment trusts and insurance separate accounts, would provide sufficient information for these purposes.

> ***Practice Tip:*** If the fund uses an ESG or sustainability rating system or index, the fiduciary, as part of its due diligence, would need to consider whether the rating system or index "evaluates one or more factors that are not financially material to investments." If so, the fund would no longer qualify as a QDIA under the rule.

Funds that use positive or negative screening may similarly result in their disqualification as a QDIA, if the screening involves non-pecuniary factors that effectively result in the exclusion of certain sectors or categories of investments, and such exclusions are reflected in the fund's investment objectives or principal strategies. If these exclusions are not reflected in the investment alternative's objectives or principal strategies, but they are otherwise disclosed, the fiduciary evaluating such fund is expected to undertake "[28]

[28] 85 Fed. Reg. 72846 (Nov. 13, 2020).

The rule does not apply to investment alternatives that are not designated investment alternatives under the plan (e.g., brokerage windows). However, the rule should not be construed as addressing the application of ERISA's duties of prudence and loyalty to brokerage windows or other non-designated investment alternatives that grant participants and beneficiaries access to investments that are not designated investment alternatives; there may be future rulemaking to address this.