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ESG Investing and Retirement Plans

Update

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Background

As ESG (environmental, social and governance) investing recently has drawn the attention of governmental agencies that oversee the administration of qualified retirement plans and their trillions of dollars in assets. This is unsurprising given that focus and interest in ESG investing has picked steam at a rapid pace in recent years. On October 30, 2020, the Department of Labor (DOL) finalized amendments to the Employee Retirement Income Security Act's (ERISA) "investment duties" regulation (the Final Investment Duties Rule). The Final Investment Duties Rule, which becomes effective on January 12, 2021, revises prior proposed amendments to the regulation that were published in June 2020.

The Final Investment Duties Rule applies to all retirement plans subject to the fiduciary duty requirements of ERISA (*e.g.*, tax-qualified defined benefit and defined contribution plans of private employers). The amendments to the Final Investment Duties Rule focus on the roles of the ERISA fiduciary duties of prudence and loyalty with respect to the evaluation and selection of ESG investments for plan purposes, though the Final Investment Duties Rule neither uses nor defines ESG and instead draws distinctions between "pecuniary" and "non-pecuniary" factors.

The DOL implemented the Final Investment Duties Rule as a result of a perceived "lack of precision and consistency in the marketplace with respect to defining ESG investments, shortcomings in the rigor of the prudence and loyalty analysis by some participating in the ESG investment marketplace, and perceived variation in some of the [DOL's] past guidance on the extent a fiduciary may consider non-pecuniary factors in making investment decisions."[1]

Related People

Matthew B. Grunert
Partner
HOUSTON
+1.713.221.1148
matt.grunert@bracewell.com

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What is ESG Investing?

ESG investing goes by many names: socially responsible investing, values-based investing, sustainable investing, responsible investing, ethical investing, impact investing, economically targeted investing. The list could go on and new terms are coined frequently.

In addition to the myriad names, each of the components of ESG investing (environmental, social and governance) focuses on its own discrete areas. Environmental concerns include climate change, land use, natural resource depletion, renewable energy, pollution and emissions. Social concerns look to the people in and around a company and focus on things like workplace health and safety, diversity and inclusion, community relations and customer care. Governance concerns typically address, among other things, board of directors composition, reasonable executive compensation, and quality of shareholder communication. ESG investing focuses on such concerns in an effort to bring positive outcomes in the areas sought to be addressed in a manner intended to provide a reasonable financial return, though maximizing such return may not always be paramount.

Given the breadth of application of ESG investing and its ever-evolving nature, it is not surprising that the DOL chose to avoid defining ESG in the Final Investment Duties Rule. The DOL cited two reasons for not providing a definition. First, the DOL stated that, "various other terms have been used to describe [ESG] and related investment behaviors . . . [and] the terms do not have a uniform meaning and the terminology is evolving, and the non-pecuniary goals being advocated today may not be the same as those advocated for in future years." In addition, the DOL was concerned that combining environmental, social and governance concerns into a unified concept may result in difficulties in evaluating whether a particular environmental, social or governance facet "presents a material business risk or opportunity to a company that corporate officers and directors should manage as part of the company's business plan and that qualified investment professionals would treat as economic considerations in evaluating investing in the company."

Fiduciary Duties Relating to Retirement Plan Investments

Before delving too deeply into the details of changes made by the Final Investment Duties Rule, it is important to understand the ERISA duties of prudence and loyalty that lie at its heart.

Pursuant to Section 404(a)(1)(A) of ERISA, fiduciaries of a plan must discharge their duties "solely in the interest of the participants and beneficiaries and for the exclusive purpose of providing benefits to participants and their beneficiaries and defraying reasonable expenses of administering the plan." This is often referred to as the duty of loyalty. The Supreme Court recently held that such interests in the context of a retirement plan refer to financial rather than non-financial benefits.[2]

Under Section 404(a)(1)(B) of ERISA, fiduciaries of a plan must discharge their duties "with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims." This is known as the duty of prudence.

The Final Investment Duties Rule

The amendments made by the Final Investment Duties Rule, which is found in DOL Regulation section 2550.404a-1, result in five changes to the prior rule. The Final Investment Duties Rule applies to both defined benefit plans and defined contributions, though certain portions of the rule are applicable only with respect to defined contribution plans, which often permit participants to select from a menu of investments made available by plan fiduciaries.

Evaluation of investment based solely on pecuniary factors

The bedrock principle of the Final Investment Duties Rule is that a fiduciary's evaluation of plan investments must focus "solely on economic considerations that have a material effect on the risk and return of an investment based on appropriate investment horizons, consistent with the plan's funding policy and investment policy objectives", which forms the definition of "pecuniary factor" in the Final Investment Duties Rule. Directly related to this is the notion that fiduciaries may not sacrifice returns, take on more risk or incur higher fees in the furtherance of non-pecuniary considerations. Notably, fiduciaries must determine prudently whether or not a particular factor is pecuniary.

Here, it is important to recognize that the Final Investment Duties Rule does not completely bar investments that take into account ESG factors. The DOL recognizes, and the use of "pecuniary" rather than "ESG" in the rule supports, that ESG factors may "present an economic business risk or opportunity that corporate officers, directors, and qualified investment professionals would appropriately treat as material economic considerations under generally accepted investment theories." The DOL provides two examples in this area. First, if a company improperly disposed of hazardous waste, such disposal "would likely implicate business risks and opportunities, litigation exposure, and regulatory obligations," all of which could impact the value of the investment. Second, the DOL points out that poor corporate governance can result in diminution of the value of an investment in a particular company.

Compliance with the duty of loyalty

The Final Investment Duties Rule requires that, for purposes of satisfying the duty of loyalty, fiduciaries must not subordinate the interests of participants and their beneficiaries in their retirement income or financial benefits under the plan to other objectives and may not sacrifice investment returns or take on additional investment risk to promote non-pecuniary considerations.

In this context, the DOL has made clear that this is a minimum standard rather than a safe harbor.

Fiduciaries must consider reasonably available alternatives

Under the Final Investment Duties Rule, when fiduciaries consider a particular investment, they must also compare that investment "to the opportunity for gain (or other return) associated with reasonably available alternatives with similar risks." The limitation of the comparison to reasonably available alternatives relieves fiduciaries of the need potentially to examine every conceivable alternative, which could consume immense time and financial resources and would not, according to the DOL, be consistent with the duty of prudence.

Tie-breakers using non-pecuniary considerations

In the event fiduciaries cannot distinguish between two investment alternatives based on pecuniary factors alone, the Final Investment Duties Rule permits, but does not require, fiduciaries to examine non-pecuniary factors to break the tie. The DOL believes that instances where investments cannot be distinguished solely on pecuniary factors should be rare and has stated that "fiduciaries are encouraged to make their best judgment on the basis of pecuniary factors alone, or where prudent to diversify by selecting all indistinguishable alternatives."

Should fiduciaries decide to break a tie using non-pecuniary factors, the Final Investment Duties Rule imposes a documentary requirement to attempt to minimize fiduciaries determining that pecuniary factors are indistinguishable. The fiduciaries must document (i) why pecuniary factors were not sufficient to pick between the alternatives, (ii) how the selected investment compares to (A) available alternatives with respect to diversification of the plan investment portfolio, (B) liquidity and current return of the portfolio relative to anticipated cash flow requirements of the plan, and (C) projected return of the portfolio relative to the funding objectives of the plan, and (iii) how the selected non-pecuniary factor is consistent with the interests of plan participants and beneficiaries with respect to their retirement income.

Even if the above documentary requirement is satisfied, the selection of the applicable investment is still subject to analysis under the duty of loyalty and act consistently with the financial interests of plan participants and beneficiaries. For instance, the DOL points out that "responding to participant demand in order to increase retirement plan savings or investments in contribution creating jobs for current or future plan participants may be consistent with the interests of participants and beneficiaries in their retirement income or financial benefits under the plan, while selecting based on which investment 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."

Finally, if ESG factors are prudently determined by fiduciaries to be pecuniary in nature, no documentary requirement similar to the above is required, though documenting reasons for such determination is good practice for ERISA purposes.

Application to Participant-Directed Accounts

The Final Investment Duties Rule makes clear that the duties of prudence and loyalty apply to fiduciaries' selection of investment alternatives in a defined contribution plan that permits participants to select from among a menu of investments (individual account plans). Selection of these investments are thus subject to the same restrictions with regard to non-pecuniary factors as discussed above.

The DOL has stated that fiduciaries considering investment alternatives for such individual account plans should review prospectuses and other investment disclosures for any information on ESG or other non-pecuniary factors that impact investment policies or approaches. With respect to open-ended investment funds, fiduciaries should begin by reviewing the funds' Form N-1A filed with the SEC.

In the event investment alternatives cannot be distinguished based on pecuniary factors, fiduciaries may take into account participants preferences as a non-pecuniary factor if using the tie-breaker describe above.

Notably, the Final Investment Duties Rule does not apply to pecuniary/non-pecuniary restriction to investments made by participants through brokerage windows, self-directed brokerage accounts and similar arrangements.

With respect to qualified default investment alternatives ("QDIAs"), the Final Investment Duties Rule imposes special restrictions. QDIAs are investments offered under an individual account plan into which a participant's account balance is placed in the absence of an affirmative investment selection by such participant. As such, the DOL believes these investments should be subject to extra protection and therefore an investment may not be used as a QDIA if the investment's objectives or goals or its principle investment strategy include, consider or indicate the use of one or more non-pecuniary factors. As with non-QDIA investments offered under individual account plans, the DOL states that a fiduciary can simply look to the investment's prospectus to determine whether impermissible non-pecuniary factors exist. The DOL also notes that fiduciaries should be aware of any "screening strategies" that investment funds may use as such strategies may move the fund toward or away from certain sectors based on non-pecuniary factors.

Effective Dates and Deadlines

The Final Investment Duties Rule, which was released by the DOL on October 30, 2020, will become effective on the 60th day following publication in the Federal Register. The rule was published in the Federal Register on November 13, 2020, and thus will become effective on January 12, 2021.

With respect to plan investments other than QDIAs, the Final Investment Duties Rule will only apply prospectively and fiduciaries will not be required to divest plans of investments that include non-pecuniary factors, even if such factors were used in selecting the investment, though fiduciaries must continue to monitor such investments on a going-forward basis. Left unanswered in this is how the Final Investment Duties Rule applies to investments that change or add non-pecuniary factors on or after January 12, 2021. In light of this, fiduciaries should proceed cautiously with respect to retaining such investments.

With respect to QDIAs, fiduciaries have until April 30, 2022, to make changes to ensure that those investments comply with the Final Investment Duties Rule.

Looking Ahead

Given the ever-evolving nature of ESG investments, fiduciaries will need to be diligent in remaining knowledgeable in this area. Even if a plan's investments do not currently include any ESG factors, it is conceivable that investments could change over time to incorporate such factors and fiduciaries will need to determine whether to retain such investments. Also, while excessive fees have been fertile ground for ERISA litigation in recent years, it is conceivable that ESG investments in qualified retirement plans could become a new litigation battleground. In all events, fiduciaries should continue to document their processes and rationales for investment selections, paying close attention to the presence of any non-pecuniary factors associated with investments.

In addition, it remains to be seen what impact, if any, the Biden administration and its Secretary of Labor will have on this topic. As the new administration is almost certain to support broad environmental and social justice initiatives, the Final Investment Duties Rule could be revised to be more accepting of ESG investing.

[1] Unless indicated otherwise, quoted material throughout is taken from the preamble to Financial Factors in Selecting Plan Investments, 85 Fed. Reg. 72846-72885 (Nov. 13, 2020) (revising 29 C.F.R. Parts 2509 and 2550).

[2] *Fifth Third Bancorp v. Dudenhoeffer*, 573 U.S. 409, 421 (2014).