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MEMORANDUM

To: Trustees, Waterfront Warehouses Local 1429 Pension Fund

From: Kimberly Bradley and Ashley Macaysa

Date: February 17, 2021

Re: DOL Final Rule on Financial Factors in Selecting Plan Investments

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Introduction

In June 2020, the Department of Labor ("DOL") issued a proposed regulation on plan fiduciaries' duties under ERISA when considering environmental, social, and governance ("ESG") factors in investment decisions. After a notice and comment period, on October 30, 2020, DOL issued a Final Rule, that was published in the Federal Register on November 13, 2020.[1] The Final Rule became effective on January 12, 2021.[2]

DOL guidance on Economically Targeted Investments ("ETIs") has shifted over time in response to political influence and changes in presidential administrations. DOL issued guidance under the Clinton administration in 1994, the Bush administration in 2008, the Obama administration in 2015, and finally the Trump administration in 2018. Democrat administrations have traditionally espoused a more favorable position on ETIs, while Republican administrations have traditionally been more restrictive. With different interpretations and conflicting corrections or clarifications over the years, it has become very difficult for fiduciaries to navigate this investment guidance, which purports to assist fiduciaries but has instead caused confusion for investors.

To add to this, the recent change in presidential administrations may impact DOL's Final Rule concerning ETIs. On January 20, 2021, the Biden administration issued a memorandum to the heads of executive departments and agencies regarding regulatory freezes.[3] President Biden also issued an Executive Order directing heads of all agencies to review all existing regulations adopted between January 20, 2017 and January 20, 2021 that are, or may be inconsistent with, the administration's policy as outlined in the Executive Order.[4] Thereafter, the Biden administration published a non-exclusive list of agency actions that heads of relevant agencies will review, in accordance with the Executive Order, wherein

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[1] 85 Fed. Reg. 72846 (Nov. 13, 2020).
[2] 29 C.F.R. §§ 2550.401c-1 et seq.
[3] See *Regulatory Freeze Pending Review*, MEMORANDUM FOR THE HEADS OF EXECUTIVE DEPARTMENTS AND AGENCIES, https://www.whitehouse.gov/briefing-room/presidential-actions/2021/01/20/regulatory-freeze-pending-review (last visited Feb. 9, 2021).
[4] See EO 13990, *Protecting Public Health and the Environment and Restoring Science to Tackle the Climate Crisis*, 86 Fed. Reg. 7037, https://www.govinfo.gov/content/pkg/FR-2021-01-25/pdf/2021-01765.pdf.

DOL's Final Rule regarding "Financial Factors in Selecting Plan Investments" was explicitly listed.[5] Notwithstanding, as the Final Rule had already taken effect prior to a change in administrations, DOL may be required to revisit the administrative rulemaking process if it wishes to make formal changes. It unclear whether DOL will enforce the Rule as written and it has yet to issue guidance on this matter. As such, the Final Rule remains in place until formal action is taken to change or nullify the Rule. An outline of the Proposed and Final Rules are detailed below.

Proposed Rule and Criticisms

The June 2020 Proposed Rule would have prohibited fiduciaries from selecting investment options based on ESG considerations unless those considerations were independently financially advantageous according to generally accepted investment theories. This would require fiduciaries to rely on "pecuniary" factors such as diversification, liquidity, and rate of return rather than ESG factors. Upon the "rare" (according to DOL) occasion where investment choices are otherwise equal, the ESG factors may be considered as a tiebreaker. In that event, the decisionmakers would be required to retain extensive documentation justifying their selections. The Proposed Rule would have required some plans to modify their investment policies and practices regarding selecting and monitoring investments, and it would likely have increased costs in the form of documentation and recordkeeping changes to meet the new requirements.

In accordance with administrative rulemaking requirements, DOL submitted the Proposed Rule for a public comment period. It received the unprecedented number of public comments, which included approximately 1,000 written comments.[6] It also received 7,600 written submissions as part of separate petitions.[7] Investing using ESG considerations has significantly increased in recent years, and many critics suggested that the Proposed Rule would restrict investments that are otherwise highly-performing investments based on ESG factors.[8] Critics suggested that the regulation unreasonably prohibits trustees from considering ESG considerations by making too broad of a prohibition. Even professionals who are in favor of the regulation in theory criticized the language, indicating it might force investors to provide inconsistent advice.[9] The harshest criticism included comments that the Proposed Rule was unnecessary, antiquated, and held a hostile view of ESG investing. Despite significant criticism, DOL moved forward with the Final Rule, stating it "believes that there are sufficient reasons to justify the promulgation of this final rule, including the lack of precision and consistency in the marketplace with respect to defining ESG investments and strategies . . . and perceived variation in some aspects of the Department's past guidance on the extent a fiduciary may consider non-pecuniary factors in making investment decisions."[10] DOL analyzed and addressed the criticism in its Final Rule, and made changes where it believed to be appropriate.

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[5] See *Fact Sheet: List of Agency Actions for Review*, https://www.whitehouse.gov/briefing-room/statements-releases/2021/01/20/fact-sheet-list-of-agency-actions-for-review (Jan. 20, 2021).
[6] Final Rule on Financial Factors in Selecting Plan Investments, § C (codified at 29 C.F.R. pt. 2550).
[7] Id.
[8] See Godbout, Ted, "DOL Takes Fire from All Sides on Fiduciary Advice Proposal," National Association of Plan Advisors (Sept. 4, 2020), https://www.napa-net.org/news-info/daily-news/dol-takes-fire-all-sides-fiduciary-advice-proposal?utm_campaign=Headlines_090820_US&utm_medium=email&utm_source=Eloqua.
[9] Id.
[10] Id. at § C.

Final Rule

The Final Rule amends the investment duties regulations of federal law which has been in place since 1979. It requires plan fiduciaries to select investments and strategies based solely on how they will affect the plan's financial performance, otherwise referred to as pecuniary goals. As mentioned, the Proposed Rule was received with significant criticism. DOL addressed the criticism head-on in the Final Rule and largely defended its position. While the Final Rule rolled back certain restrictions and burdens from the Proposed Rule, DOL reaffirmed its position that ERISA requires fiduciaries to treat financial interests as paramount when making investment decisions. DOL emphasized that the main purpose of the regulatory action remained the same:

> Under the Final Rule, plan fiduciaries, when making decisions on investments and investment courses of action, must focus solely on the plan's financial risks and returns and keep the interests of plan participants and beneficiaries in their plan benefits paramount. The fundamental principal that an ERISA fiduciary's evaluation of plan investments must be focused solely on economic considerations that have material effect on the risk and return of an investment based on appropriate horizons, consistent with the plan's funding policy and investment policy objective. The corollary principle is that ERISA fiduciaries must never sacrifice investment returns, take on additional risk, or pay higher fees to promote non-pecuniary benefits and goals.[11]

Despite dismissing and disagreeing with much of the criticism, the Final Rule implemental several important changes in response to public comments. Similar to the Proposed Rule, the Final Rule makes five major amendments to the investment duties regulation under Title 1 of ERISA:

1. The Final Rule confirms that ERISA fiduciaries must evaluate investments and investment courses of action based solely on pecuniary factors, or those financial considerations that have a material effect on the risk and/or return of an investment consistent with the plan's investment objectives and funding policy.[12]
2. An express regulatory provision is added stating that compliance with the exclusive purpose (loyalty) duty in ERISA section 404(a)(1)(A) prohibits fiduciaries from subordinating the interests of participants to unrelated objectives, barring them from sacrificing investment return or taking additional risks to promote non-pecuniary goals.[13]
3. The Final Rule adds a provision requiring Fiduciaries to consider reasonably available alternatives to meet their prudence and loyalty duties under ERISA.[14]
4. New text is added to set forth required investment analysis and documentation for circumstances in which plan fiduciaries use non-pecuniary factors when choosing between investments where the Fiduciaries are unable to distinguish on the basis of pecuniary factors alone.[15]

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[11] Id. at § B.
[12] Id. (codified at 29 C.F.R. pt. 2550.404a-1(c)).
[13] Id. (codified at 29 C.F.R. pt. 2550.404a-1(c))
[14] Id. (codified at 29 C.F.R. pt. 2550.404a-1(b)(2)).
[15] Id. (codified at 29 C.F.R. pt. 2550.404a-1(c)(2)).

5. Finally, the Final Rule states the prudence and loyalty standards set forth in ERISA apply to a fiduciary's selection of designated investment alternatives to be offered to plan participants and beneficiaries in a participant-directed individual account plan.[16][17]

The most significant change from the Proposed Rule to the Final Rule is the removal of reference to ESG factors. DOL agreed with the commenters that reference to ESG considerations for investments is often vague and inconsistent.[18] ESG has often been used interchangeably with the terms ETI, impact investing, sustainability and non-financial performance metrics, with no uniform meaning.[19] Therefore, the Final Rule no longer explicitly refers to ESG factors, but rather uses the term "pecuniary factors," defined as those factors with a material demonstrable impact on investment performance.[20] Although the Proposed Rule was seen as virtually eliminating the use of ESG, or socially responsible, factors in investment decisions, the Final Rule leaves room for these types of considerations in investments if assessed from a purely economic manner. It states that ERISA fiduciaries should consider all relevant factors in evaluating whether there may be a material effect on the return and risk of an investment. Further, when comparing investment alternatives, the Final Rule resolved that a fiduciary is only required to compare alternatives that are "reasonably available under the circumstances."[21] This is intended to confirm that the rule does not require fiduciaries to scour the market and consider every alternative and is consistent with language in prior DOL publications.[22]

When discussing the "tie-breaker" or "all things being equal" portion of the rulemaking, DOL chose not to explicitly incorporate a tie-breaker provision by name, but generally allow for a modified tiebreaker. The language from the Proposed Rule was simplified in the Final Rule to focus on situations in which a fiduciary is unable to distinguish investment alternatives on the basis of pecuniary factors alone, and removes the stringent documentation requirements of the Proposed Rule in favor of a simplified documentation.[23] Specifically, when a fiduciary is unable to determine which investment is in the best interests of the plan based on pecuniary reasons alone, non-pecuniary factors can be considered so long as the fiduciary documents why pecuniary factors were not sufficient to select the investment, how the investment compares to the alternative investments, and how the non-pecuniary factors are consistent with the interests of participants and beneficiaries of the plan.[24]

The Final Rule also adds a caution to multiemployer plans. The language makes very clear that increasing participant contributions or otherwise benefitting union labor is generally not a pecuniary factor that may be considered outside the tie-breaker context.[25] "The purpose of plan investments under ERISA is to provide and protect retirement benefits – not to strengthen employers or unions or provide job security."[26] A fiduciary's investment duties are satisfied if the fiduciary gives appropriate consideration to facts and circumstances that the fiduciary knows or should know are relevant to the particular

[16] Id. (codified at 29 C.F.R. pt. 2550.404a-1(d)).
[17] This portion of the Final Rule would only apply to self-directed defined contribution plans, and therefore it would not apply to the Waterfront Warehouses Local 1429 Pension Fund.
[18] Final Rule, § D.2.
[19] Id.
[20] Id.
[21] Id. at § D.1.
[22] Id.
[23] Id. at § D.3.
[24] Id.
[25] Id. at § D.2.
[26] Id.

investment and acts accordingly.[27] In doing so, fiduciaries should focus on non-pecuniary factors in selecting investment courses of action, and must never sacrifice investment returns, take on additional risk, or pay higher fees to promote non-pecuniary benefits and goals.

Conclusion

While the Final Rule regarding "Financial Factors in Selecting Plan Investments" became effective on January 12, 2021, the Biden administration has explicitly called upon DOL to review its Rule. At present, it is unclear how and when DOL will make changes or issue guidance on this matter. It is also unclear whether DOL will enforce the regulations as written. If you have any questions about this guidance, please feel free to contact us.

[27] Id. (codified at 29 C.F.R. pt. 2550.404a-1(b)(1)(i)).