Case(s) in Point

On the litigation front, the lawsuits against fiduciaries that included BlackRock's Lifepath target-date funds on their menus continue to be dismissed—although most have allowed a short time for those bringing those suits to correct the shortcomings in their suits. And most of the excessive fee suits that have gone to trial have been dismissed for failing to meet a standard of plausibility in their arguments, with the courts generally finding that more than a fee allegation based solely on the size of allegedly comparable plans is required.

But the big potential litigation news of the quarter came from a Florida court that overturned a key aspect of the Labor Department's fiduciary rule regarding rollovers. Details follow.

Rollover Rollback?

Court rolls back rollover rule in 401(k) fiduciary FAQ fight

A financial services trade group has prevailed in a key portion of its suit against the Department of Labor's fiduciary guidance involving rollovers.

The U.S. District Court's Middle District of Florida sided with the American Securities Association. It ruled that the DOL overstepped its authority with certain parts of its Frequently Asked Questions (FAQs) regarding Prohibited Transaction Exemption 2020-02.

As the court noted, the DOL issued a set of FAQs in April 2021, where, among other things, they addressed the point at which advice to roll over assets from an employee benefit plan to an IRA is considered to be on a "regular basis."

It also clarified when financial institutions and investment professionals must consider and document the "specific reasons" a rollover recommendation was thought to be in the client's best interest.

The suit focused on two FAQs in particular, FAQs 7 (regular basis) and 15 (specific reasons). Plaintiffs argued that FAQ 7 unlawfully enlarged "the circumstances in which an investment advisor is subject to fiduciary duties." It thus would subject ASA members to the increased and expensive documentation requirements

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detailed in FAQ 15, which plaintiffs claimed were undue and burdensome.

The court first determined that at least one wealth management member[1] of the association bringing the suit had suffered an injury as a result, and commented that, "The policy referenced in FAQ 7 deviates from past agency guidance by explaining that the one-time provision of advice to roll over assets from a plan to an IRA can, in certain circumstances, trigger fiduciary duties." The court then determined that "the policy referenced in FAQ 7 contradicts the plain language of the rule it purports to interpret."

More specifically, "Because the policy referenced in FAQ 7 abandons this plan-specific focus in the context of rollovers, it sweeps conduct into its purview that would not otherwise trigger fiduciary obligations."

The court agreed with the American Securities Association on FAQ 7 and declared it unlawful, noting, "Because the policy referenced in FAQ 7 conflicts with the Department's existing regulations, it is an arbitrary and capricious interpretation of the 1975 Regulation." It vacated the policy as a violation the Administrative Procedures Act (APA) and "remanded it to the Department of Labor for further proceedings consistent with this Order."

Yet it found that the policy referenced in FAQ 15 was not arbitrary and capricious and sided with the DOL.

"In short, the type of documentation that FAQ 15 requires is precisely of the nature that a prudent investment advisor would undertake," the court held. "Accordingly, it neither contradicts the 2020 Exemption nor goes beyond it. The Court finds that the policy referenced in FAQ 15 is not arbitrary and capricious."

In fact, while the plaintiffs had asked for summary judgment on four separate counts, they prevailed on only one—though it was a big one in terms of potential long-term implications.

What It Means for Fiduciaries

"While the DOL won on the question of whether the procedure outlined in FAQ 15 was appropriate, they lost on the bigger issue of the re-interpretation of the fiduciary rule for rollovers," noted ERISA attorney Fred Reish, a partner with Faegre Drinker Biddle & Reath LLP. "If an advisor or agent isn't a fiduciary, then a rollover recommendation won't be a prohibited transaction, and PTE 2020-02 and the FAQ 15 process won't be needed."

That said, Reish believes the decision will be appealed, and the final outcome will not be known for at least a year. As a result, "it would be risky to rely on the opinion until there is a final decision at a higher level than this trial court," he added.

Tom Clark, a partner with the Wagner Law Group, said advisors should contemplate staying the course until more is known.

"It's a blow to the Department of Labor, but if you're acting in people's best interest under PTE 2022-02 now, you should consider continuing to do so until the consequences of this decision become clearer," he explained. "This will almost certainly not be the DOL's last word on the issue."

As for the next steps, Brian Graff, CEO of the American Retirement Association, said the court's decision was based on its determination that the language of FAQ 7 went beyond that permitted by the Administrative Procedures Act.

"The DOL may well respond to this decision regarding the FAQs by modifying or eliminating the 'regular basis' prong of the five-part test in the regulation itself in its pending, proposed changes to the fiduciary rule," he concluded.

— John Sullivan/Nevin Adams

Venue View

Participants challenge ESG rule in different venue

"For Americans of all races, creeds, and political stripes, the American dream includes the prospect of a comfortable retirement." So begins a second lawsuit challenging the Labor Department's so-called ESG rule.[2]

However, while that one was brought by roughly half the Attorneys General in the country (along with a plan sponsor and an unrelated plan participant), this one was brought in a different federal court (the U.S. District Court for the Eastern District of Wisconsin) by participants Richard Braun (Operations Manager for SWAT Environmental, a soil, water, and air technologies company that provides radon mitigation and other services), and Frederick Luehrs III (a Maintenance Supervisor at Petron Corporation, a supplier of engineered lubricants, in New Berlin, WI)—both of whom participate in the respective defined contribution plans of their employers.[3]

Proposed 'Sell'?

But despite the differences in venue (Wisconsin rather than Texas), the arguments are much the same—and in many respects focus more on the more provocative positioning in the proposed regulation than on the final one.

"The fundamental principle that retirement investments are made for the benefit of retirees is now under attack via the guise of an investing fad often referred to as 'ESG,' which by its nature focuses on environmental, social, and governance goals rather than maximizing investment returns," the suit alleges. "Whatever euphemism one wishes to use—'people over profits,' 'standing for something more,' etc.—the ESG investment trend contemplates a focus on policy objectives rather

FOOTNOTES

[1] Specifically, the court noted that "as the regulated party, Baird no longer provides rollover recommendations because of this guidance. This is sufficient to demonstrate that at least one ASA member has suffered an injury-in-fact for standing purposes."

[2] It's actually called "Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights."

[3] The Wisconsin Institute for Law & Liberty represents the plaintiffs.

than financial returns. This ERISA forbids."

Noting that the ESG rule "stems from a broader executive initiative," the suit (*Braun v. Walsh*, E.D. Wis., No. 2:23-cv-00234, complaint filed 2/21/23) goes on to state that," …Congress never granted President Biden the authority to override ERISA's text and its stated objective to protect retirees in favor of progressive policy dreams like social credit scores, reducing pay for CEOs, or instituting racial quotas for corporate boards." More precisely, the plaintiffs state that "the ESG Rule violates ERISA and exceeds the authority granted to the Secretary by statute. In addition, it unlawfully politicizes the retirement system and, in doing so, puts the retirement savings of millions of Americans at substantial risk in service of a policy choice not found in ERISA or otherwise enacted by Congress."

Exceeds Authority

In response, they claim to be "entitled to a declaration that the ESG Rule exceeds the authority conferred on the Secretary and the Department by Congress, and a preliminary and permanent injunction enjoining the ESG Rule."

The suit proceeds to outline the history of the "focus on financial return" that it notes "has been consistent in federal rules and regulations over the nearly three decades between 1994 and the present day, regardless of what party controlled the White House during that time," and then goes on (harkening back to the 2020 rule) to note that since that time "fiduciaries have been free to select investments that account for ESG factors, provided that the pecuniary factors underlying these investments and other investment options are equivalent and that fiduciaries document for the participants and beneficiaries the reasoning for their choices."

As did the previous suit by 25 state Attorneys General, these plaintiffs bemoan the removal of a specific documentation requirement contained in the Trump administration's version, commenting that that "documentation requirement provides protection for plan participants and beneficiaries and ensures that fiduciaries will only consider these non-economic factors when doing so will not put the economic returns of participants and beneficiaries at risk at the expensive of collateral objectives."

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> **“The ESG Rule … will fundamentally alter the focus on investment returns for plan participants and beneficiaries, instead injecting consideration of ESG factors—but without requiring that fiduciaries quantify the benefits of any such factors, or even document the reasoning behind their consideration.”**

The plaintiffs then turn their attention to the sequence of events following the Biden administration coming to power, beginning with their announcement that they would not enforce the 2020 Rule “despite that rule having gone through the complete rulemaking and public comment process.”

Provocative Positioning?

Again, most of the criticism here seems focused on the (admittedly) more political (and arguably provocative) positioning of the rule initially proposed by the Biden administration. The plaintiffs here caution that “a rule that endorses or provides cover for selecting investments based on factors other than financial returns necessarily disadvantages individual employees and participants,” glossing over the reality that the final regulation seems very much in concert with that position.

Indeed, they point out that “the ESG Rule, initially proposed in October 2021 to supersede the 2020 Rule and finalized on December 1, 2022, will fundamentally alter the focus on investment returns for plan participants and beneficiaries, instead injecting consideration of ESG factors—but without requiring that fiduciaries quantify the benefits of any such factors, or even document the reasoning behind their consideration.” The documentation requirement referenced is, of course, to be found in the Trump administration’s own ESG rule—which called for specific analysis and documentation in “the rare circumstances when fiduciaries are choosing among truly economically ‘indistinguishable’ investments.”

The suit questions returns on ESG options, as well as alleging that those options carry higher fees.

In another “lookback” to the proposed rule, the plaintiffs point to text in the Biden administration’s proposed rule that said proper fund evaluation “may often require an evaluation of the economic effects of climate change and other ESG factors” that was specifically rejected in the final rule. It cited the elimination[4] of the aforementioned special documentation requirement (in favor of the standard review/process long applied to all plan investments) as a diminution of fiduciary protection—claiming that even with the removal of those special considerations, “the spirit of the proposed rule—to favor investments based on these non-pecuniary factors—remains.”

‘Required’ Removal

Indeed, the plaintiffs here claim that “the ESG Rule and its summary employs two primary vehicles to achieve these objectives: 1) language authorizing and encouraging consideration of ESG factors; and 2) elimination of documentation requirements for ‘tiebreaker’ inquiries.” They go on to state that “while this language, combined with the removal of the word ‘required,’ may appear to solve the problems associated with the Proposed Rule at first glance, the remainder of the regulation, along with the lengthy summary, makes clear that these ESG investments are favored under the new regulation despite a lack of evidence that they provide increased returns for investors.”

Also in the spirit of alleging less protections for participants, the plaintiffs viewed the Trump administration’s initial prohibition of ESG target-date funds as qualified default investment alternatives (QDIA) as a protection now removed.

The plaintiffs characterize the Labor Department’s rationalization of the need to issue a new regulation to counter confusion of terms like “pecuniary,” and the notion that the previous regulation had a “chilling effect” on consideration of ESG factors, as unnecessary at best—and at worst, exactly the opposite of what the final regulation claims to do: putting the financial interests of plan participants and beneficiaries above all other considerations.

The suit concludes: “Unless the Secretary is immediately restrained from implementing the ESG Rule, Plaintiffs and millions of American participants and beneficiaries like them face a substantial likelihood that their retirement contributions will be invested in a manner inconsistent with the statutory requirement that contributions be invested solely in their interest.”

We’ll see.

— Nevin E. Adams, JD

FOOTNOTES

[4] The plaintiffs here claim that there “are only two plausible reasons why the Department would eliminate a documentation requirement. One would be to eliminate any realistic chance of a participant proving a breach of the duty of prudence and loyalty if a fiduciary subverts the participants’ economic return to collateral considerations.” As for the second reason, the plaintiffs state that “it is difficult, if not impossible, to quantify the economic impact of the ESG factors the ESG Rule, whether in the short or the long term.”