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Does the Recently Amended Investment Duties Regulation Change How Fiduciaries Are Expected to Make Investment Decisions for Employee Benefit Plans?

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Introduction

The more things change the more they stay the same. Or do they? This question should be on every employee benefit plan fiduciary's mind after January 12, 2021, when an amended U.S. Department of Labor ("DOL") regulation went into effect changing the standards under which fiduciaries are expected to make investment decisions for ERISA employee benefit plans.

On his first day in office President Biden signaled that his administration will review the Final Rule on Investment Duties as part of his Executive Order on "Protecting Public Health and the Environment and Restoring Science to Tackle the Climate Crisis." The implemented Final Rule, however, is notable as much for what it does not do as for what it does. The amended regulation that the DOL had proposed on June 30, 2020 was centered on new standards for consideration of environmental, social, and corporate governance factors—referred to as "ESG" factors—in connection with employee benefit plan investing. The DOL received over 8,700 comments in response, in which mutual fund companies, unions, law firms, and academics argued that the proposed regulation was deeply flawed. Some of the critics argued that the proposal improperly discouraged benefit plan investing in vehicles with ESG goals or objectives; others claimed that it improperly created higher standards for fiduciary consideration of ESG factors in evaluating investment options.

After the tidal wave of criticism, the DOL issued a Final Rule that eliminated all overt references to consideration of ESG factors.

Eliminating references to ESG factors altered the nature of the proposed amendment. The Investment Duties regulation left standing instead changes how *all* fiduciaries are to approach all investment decision-making in connection with all types of employee benefit plans. Under the new rule, fiduciaries are instructed to make investment decisions by considering only "pecuniary" factors, as defined by the DOL, to the exclusion of "non-pecuniary" factors, with limited exceptions. The new standard adopts the idea that loyalty to plan interests requires the exclusion of any other interest, including collateral benefits or goals of an investment, which could include ESG factors.

While the rule itself is stark, the Preamble adopts a looser interpretation of what can be considered "pecuniary" factors. Further, as explained below, the rule weaves in guidance previously published by both Democratic and Republican administrations and does not prohibit fiduciary selection of investments with collateral benefits or ESG goals so long as the selection is based solely on "pecuniary" factors as defined in the Final Rule, or in compliance with an exception.

It will be interesting to see whether the Biden administration is interested in changing the amended rule itself or just massaging the interpretation, and whether the DOL will explicitly embrace consideration of ESG factors in employee benefit plan investing or leave the amended regulation alone after all. As explained further below, the Final Rule's changes to existing guidance are nuanced, and allow for benefit plan fiduciaries to consider all types of investments, including ESG focused vehicles, albeit through a narrower lens.

Background

The DOL originally promulgated the Investment Duties regulation, 29 CFR §2550.404a-1, in 1979 providing guidance on complying with the fiduciary duty of prudence in making investment decisions. This is the first amendment to the Investment Duties regulation since its adoption more than 40 years ago.

As chronicled in the Final Preamble, beginning in 1994 the DOL issued a series of Interpretive Bulletins advising on fiduciary decision making where an investment could have collateral benefits beyond anticipated monetary investment returns. The DOL had explained in Interpretive Bulletin 2015-01, 29 CFR 2509.2015-1, that "the fiduciary standards applicable to [economically targeted investments] are no different than the standards applicable to plan investments generally" and thus that a fiduciary does not violate fiduciary duties by considering collateral benefits in investment decision making as long as plan interests are not subordinated to unrelated objectives and "fiduciaries [do] not accept lower expected returns or take on greater risks in order to secure collateral benefits." In the Preamble to Interpretive Bulletin 2015-01 the DOL noted that fiduciaries could consider collateral benefits in selecting an investment as long as it was economically equivalent to an investment without collateral benefits, which came to be known as the "tie-breaker" rule. Field Assistance Bulletin 2018-01 later expanded this guidance by first explaining that ESG factors can represent business risk or opportunity and thus should be considered along with other economic factors, not only as tie breakers, and then noting that fiduciaries "must not too readily treat ESG factors as economically relevant" and must always put a plan's economic interests first.

Fiduciary Duties of Prudence and Loyalty in Investment Decisions

The 1979 Investment Duties regulation is a safe harbor, offering fiduciaries a road map to complying with the fiduciary duty of prudence in ERISA Section 404(a)(1)(B) when evaluating investment options. The amended version of the regulation retains the safe harbor for the duty of prudence and adds standards for complying with the fiduciary duty of loyalty in ERISA Section 404(a)(1)(A), which is described as a "legal requirement and not a safe harbor."

Fiduciary Duty of Loyalty: Pecuniary Factors Must Govern Investment Decisions, 29 CFR §2550.404a-1(c)(1), (f)(3)

The bedrock principle in the DOL's prior serial guidance on investment decision making was that the ERISA fiduciary duty of loyalty required that fiduciaries place a plan's financial interests first and paramount and make decisions solely in the interests of providing benefits to a plan's participants and beneficiaries in the context of the relevant circumstances.

The DOL's reimagined approach demands that fiduciaries consider only defined pecuniary factors in making investment decisions to the exclusion of other, non-pecuniary, factors. A "pecuniary factor" is defined as a factor "that a fiduciary prudently determines is expected to have a material effect on the risk and/or return of an investment," and a "fiduciary's evaluation of an investment or investment course of action must be based only on pecuniary factors." The new rule thus defines pecuniary factors by exclusion as much as inclusion.

The "pecuniary factors" definition in the Final Rule is broader than as originally proposed, presumably in response to criticism that it was too rigid. The revised definition of "pecuniary factors" incorporates a touch of fiduciary responsibility by adding that a fiduciary must "prudently determine" what factors are expected to have a material effect on an investment's risk and return. Thus, as explained in the Preamble, fiduciaries may consider all relevant factors in evaluating what might have an effect on the return and risk of an investment, noting, for example, that "[i]f a fiduciary were to prudently conclude that a fund manager's brand or reputation will materially affect the expected risk and/or return [of] funds, then such factors would be pecuniary." Further, fiduciaries are not required to choose the lowest cost option if the circumstances support prudently selecting a higher cost option, and fiduciaries are not prohibited from considering factors such as shared fees in evaluating investment options.

Although the softening of the defining language is welcome, and the Preamble's suggestion that fiduciaries can still consider relevant facts and circumstances in their analyses is instructive, the text of the amended regulation is still novel, and fiduciaries will need to determine whether the regulatory changes in concert with the DOL's interpretative suggestions in the Preamble will require changes in their approach to considering investment options.

Fiduciaries should also recognize that the amended regulation does not prohibit or discourage selection of an investment vehicle based on defined pecuniary factors that happens to have ESG or other collateral benefits or goals. That is, the regulatory guidance requires laser focus on defined pecuniary characteristics without comment on other features of an investment option. Moreover, the regulation as implemented no longer sets different standards for consideration of ESG factors; fiduciaries may determine that ESG factors are expected to have a material effect on the risk/return of an investment and thus are appropriate pecuniary factors to consider in evaluating an investment option.

Despite the implemented regulatory language, however, the Preamble is still dominated by skepticism of ESG factors and could be read to chill fiduciary interest in evaluating such vehicles. The Biden Administration may be interested in recasting the DOL's interpretation to more closely align with the final regulatory language and eliminate overt or implied suggestions that fiduciaries should avoid investment vehicles with ESG benefits or goals.

Using Non-Pecuniary Factors to Make Investment Decisions, 29 CFR §2550.404a-1(c)(2)

The Final Rule includes an exception, allowing fiduciaries to "use non-pecuniary factors as the deciding factor in the investment decision" if a plan fiduciary is unable to distinguish between investment alternatives on the basis of pecuniary factors alone, as long as the decision is quantified by documenting compliance with specified standards. This modified "tie breaker" analysis departs from prior DOL guidance that allowed fiduciaries to consider collateral benefits when investments were economically comparable, without needing to first conclude that a decision could not be made based on pecuniary factors alone. The final standard is less rigid than the proposed standard, which would have required that investment options be economically indistinguishable before considering non-pecuniary factors, which both the DOL and critics recognized was a near impossibility. Even with the modified rule, however, a fiduciary will need to conduct additional analysis and maintain additional documentation in order to justify using "non-pecuniary factors as the deciding factor" in selecting an investment opportunity.

The high bar for considering non-pecuniary factors underscores the amended regulation's direction that fiduciaries must select investments solely based on pecuniary factors.

The recast "tie breaker" provision makes it harder for fiduciaries to consider an investment's collateral benefits or goals, whereas prior DOL guidance had made it easier. The Biden Administration may be interested in removing the added documentation requirements that could discourage such considerations, or in reinstating earlier guidance that relied on fiduciary discretion to consider all relevant facts and circumstances. It is unlikely, however, that the Biden Administration would stray from the underlying legal principle that the duty of loyalty requires that a plan's financial interests be first and paramount in making investment decisions, or suggest that investment decisions for ERISA plans can be made using non-pecuniary factors absent specified circumstances.

Prohibitions on Prioritizing Collateral Benefits or Goals, 29 CFR §2550.404a-1(c)(1)

The new regulation also formalizes existing guidance on what fiduciaries should not do in making investment decisions. Echoing what the DOL has asserted in informal guidance over the years, it states that fiduciaries may not subordinate plan interests to other objectives, and that fiduciaries may not sacrifice investment returns or take on added risk to promote collateral benefits or goals.

The Final Rule tucks these statements of what fiduciaries should not do in between the pronouncement that fiduciaries must only consider pecuniary factors and the directive that "the weight given to any pecuniary factor by a fiduciary should appropriately reflect a prudent assessment of its impact on risk-return." The placement is curious; the direction to make decisions based only on the anticipated risk-return impact of pecuniary factors would not allow for subordinating plan interests to collateral benefits or goals. It will be interesting to see whether the DOL and the courts treat the prohibitions on prioritizing collateral interests as embedded within the exclusive consideration of pecuniary factors requirement or as a separate standard. It is also unlikely that the Biden Administration would change or comment on these provisions, which have been consistent in DOL guidance throughout multiple administrations.

Fiduciary Duty of Prudence: Safe Harbor, 29 CFR §2550.404a-1(b)

The original 1979 guidance for complying with the fiduciary duty of prudence in evaluating investment options remains largely intact in the Final Rule. The safe harbor regulation continues to explain that a fiduciary acts prudently in making investment decisions if he gives "appropriate consideration" to relevant facts and circumstances, including considering the role an investment plays in a plan's portfolio.

Existing subsection (b)(2) continues to offer guidance on how to demonstrate "appropriate consideration" of relevant facts, including by comparing investment options to "reasonably available alternatives" with similar risk/return characteristics.

Comparing investment vehicles is an established best practice in investment decision-making for ERISA employee benefit plan fiduciaries, though it had not previously been described in this regulation as an element of compliance with the fiduciary duty of prudence. The proposed regulation had raised concerns because it had seemed to suggest that comparison was mandatory for all investment analyses, or that a fiduciary was expected to consider all potential alternatives. The final regulatory language settled on comparison with "reasonably available" alternatives, giving fiduciaries more flexibility in deciding when and how comparisons will aid in making investment decisions.

This expanded regulatory language is not expected to require significant changes to existing practices for fiduciaries that already utilize this best practice as a tool to evaluate investment options. The regulatory language is catching up with the practice, rather than influencing it.

Fiduciary Duties of Prudence and Loyalty: Investment Options for Participant-Directed Individual Account Plans, 29 CFR §2550.404a-1(d)

The amended Investment Duties rule also charts new territory by specifically describing fiduciary obligations of prudence and loyalty in connection with selecting designated investment alternatives for self-directed individual account retirement savings plans. This new rule is described as a "legal requirement not a safe harbor."

The Final Rule specifically states that the duties of prudence and loyalty described in the amended regulation apply to fiduciary "selection or retention of designated investment alternatives" available to participants in self-directed plans. The Final Rule is much simpler than the proposed rule, which had caused great concern that the DOL was setting different fiduciary standards for decisions relating to self-directed retirement plans, including selection of ESG investment vehicles.

The Final Rule explains that fiduciaries of self-directed plans are not prohibited from selecting or retaining investment vehicles with non-pecuniary objectives or goals for their investment menus as long as they comply with their fiduciary duties of prudence and loyalty as described in the amended regulation, and make selections based only on pecuniary factors or under the described exception. The Preamble states the guidance more directly, noting that investment vehicles with ESG or other collateral benefits or goals may be included in an investment menu as long as they are selecting based on pecuniary factors, and that fiduciaries could choose investments based on non-pecuniary objectives or goals using the modified tie-breaker exception by citing plan participant preference for such options.

The final amended regulation makes one exception, however, singling out Qualified Default Investment Alternatives (QDIAs), the default investment option fiduciaries choose when a participant has not made their own choice for their account. Fiduciaries are specifically prohibited from selecting investment vehicles with non-pecuniary objectives or goals as QDIAs. This prohibition bolsters the conclusion that the amended regulation does not prohibit fiduciaries from selecting investment vehicles with non-pecuniary objectives or goals in any other circumstance, as long as fiduciaries comply with their fiduciary obligations in making investment decisions.

In its review the Biden Administration presumably will recognize that this subsection relies upon and applies the amended fiduciary standards to the specific fiduciary function of selecting investment options for self-directed defined contribution plans and that it expressly allows fiduciaries to evaluate and select investment vehicles with ESG or other collateral benefits or goals. The Biden Administration might explicitly adopt this guidance as an example of how fiduciaries are to approach investment decision making under the amended standards for any type of plan, including when considering options that have ESG or other collateral benefits or goals; the overall regulatory language already allows for that interpretation. The Biden Administration may also be interested in revisiting the prohibition on QDIAs, which could be seen as an unnecessary restriction on selection of a specific type of investment option.

Conclusion

Late in 2020, the DOL amended its Investment Duties regulation for the first time in 40 years. In the end, the Final Rule on investment decision making that emerged from the filter of constituent comments does not prohibit fiduciaries of ERISA employee benefit plans from selecting investments that have ESG or other collateral objectives or benefits, and does not create different standards for consideration of such investment options. Rather, the amended regulation requires that fiduciaries make investment choices based on consideration of pecuniary factors, which is consistent with the DOL's existing guidance. The Final Rule does, however, shift focus from considering investment options under the totality of the facts and circumstances to considering only defined pecuniary factors to the exclusion of non-pecuniary factors. This could be a distinction without a difference, however, given the expanded interpretation in the Preamble and the flexibility incorporated into the final regulatory language.

The Biden Administration flagged this rule for review under the umbrella of an Executive Order focused on public health, the environment and climate change. Given that the slimmer Final Rule is no longer the stranglehold on ESG investing that the original proposal had been, the Biden Administration could decide not to expend its resources changing it. Instead, it could opt for reminding benefit plan fiduciaries that, despite the prior administration's efforts, the DOL does not restrict fiduciary consideration of relevant factors in selecting investments for employee benefit plans, including when considering investment vehicles with ESG or other collateral benefits or goals.

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