June 26, 2020

U.S. Department of Labor Announces Proposal Affecting Plan Fiduciaries and ESG Investments

SUMMARY

On June 23, 2020, the U.S. Department of Labor released a proposal for a new investment duties rule. The proposal clarifies the application of the fiduciary duties of prudence and loyalty under the Employee Retirement Income Security Act of 1974, especially with regard to possible non-financial goals, including environment, social and public policy factors. In particular, the clarifications proposed in the press release provide greater specifications of when a plan fiduciary is prohibited from considering non-pecuniary interests and certain circumstances where such considerations are appropriate.

SUMMARY OF LABOR PROPOSAL

On June 23, 2020, the Employee Benefits Security Administration division of the U.S. Department of Labor ("Labor") proposed a new rule ("Proposal"), which would guide its interpretation of certain fiduciary duties under the Employee Retirement Income Security Act of 1974 ("ERISA").[1] Particularly, the proposed rule seeks to clarify the application of the duties of "prudence" and "exclusive purpose" under ERISA in circumstances where a plan fiduciary may select investments for non-financial reasons, including environment, social and public policy goals ("ESG").

A. BACKGROUND ON APPLICABLE ERISA FIDUCIARY DUTIES

Under Section 404(a)(1)(A) and (B) of ERISA, a plan fiduciary must, in addition to other enumerated duties, "discharge his duties with respect to a plan…(A) for the exclusive purpose of: (i) providing benefits to participants and their beneficiaries; and (ii) defraying reasonable expenses of administering the plan" (colloquially known as the exclusive-purpose or loyalty duty), as well as 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". As Labor's Proposal notes, courts have interpreted the "exclusive purpose" duty to require fiduciaries to focus solely on the interests of participants and beneficiaries, with the Supreme Court emphasizing that such interests are "financial" rather than "nonpecuniary".[2]

B. MAIN COMPONENTS OF PROPOSAL

The primary purpose of the Proposal is to state clearly that fiduciaries may not prioritize "non-pecuniary" goals at the expense of the financial interests of participants and beneficiaries in retirement income, although it does still allow for consideration of ESG and other non-financial goals in certain circumstances. The main components of the Proposal include:

- Codification of the requirement that plan fiduciaries choose investments and investment strategies based on financial considerations.
- An express statement that plan fiduciaries, to satisfy the "prudence" and "exclusive purpose" duties, may not subordinate participants' and beneficiaries' interests for non-monetary, the fiduciary's or another's interests.
- A new requirement that fiduciaries must, when considering a particular investment, compare other available investments with regard to certain specified factors (including, level of diversification, degree of liquidity, potential risk and return, among others). The enumerated factors provide some guidance as to what should be appropriate considerations but the Proposal says the list is not exhaustive.
- A specification that ESG factors may be used in investment decisions and strategies if they present economic risks or opportunities, which are measured as those a "qualified investment professional would treat as material economic considerations under generally accepted investment theories". It also adds proposed new text on investment analysis and documentation requirements if a plan fiduciary is choosing among economically "indistinguishable" investments.
- An original provision about selecting designated investment alternatives for 401(k)-type plans. The Proposal restates that prudence and loyalty both apply to the selection of an investment alternative in a 401(k)-type plan but it also describes requirements for selecting such investment alternatives when the alternative has one or more ESG-related objectives in its investment strategies or includes such parameters in the fund name.

C. APPLICATION OF PROPOSAL

The Proposal, if enacted, would affect fiduciaries of ERISA-covered plans, which only include ***private*** retirement plans.

D. RELATED TRENDS

While this Proposal stands in contrast to the recent focus on the import of ESG goals, it appears to follow a similar interpretation from the Securities and Exchange Commission ("SEC"), effective July 12, 2019.[3] This SEC interpretation emphasized that investment advisers "must, at all times, serve the best interest of its client and not subordinate its client's interest to its own" and followed comments made by Chairman Jay

Clayton in December 2018 that "advisers cannot put their own interests ahead of the interests of their clients", including interests related to ESG matters.[4]

E. FUTURE IMPLICATIONS OF PROPOSAL

At this stage, the Proposal is still subject to a notice and comment period before becoming effective. Ultimately, when, and if, this Proposal is enacted, plan fiduciaries should take care to consider the circumstances under which they consider ESG-related goals and other non-pecuniary interests when making investment decisions for private retirement plans.

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ENDNOTES

1 The full proposal is available at https://www.dol.gov/sites/dolgov/files/ebsa/temporary-postings/financial-factors-in-selecting-plan-investments-proposed-rule.pdf. The U.S. Department of Labor's press release is available at https://www.dol.gov/newsroom/releases/ebsa/ebsa20200623-0.

2 *See*, *e.g.*, *Donovan* v. *Mazzaola,* 716 F.2d 1226 (9th Cir. 1983) (quoting *Freund v. Marshall & Ilsley Bank*, 485 F. Supp. 629 (W.D. Wis. 1979); *Donovan* v. *Bierwirth*, 680 F.2d 263 (2d. Cir. 1982); *Fifth Third Bancorp* v. *Dudenhoeffer*, 573 U.S. 409 (2014).

3 *See* our memorandum to clients "The Rise of Standardized ESG Disclosure Frameworks in the United States", dated June 8, 2020.

4 U.S. Sec. and Exch. Comm'n, Commission Interpretation Regarding Standard of Conduct for Investment Advisers (July 12, 2019) https://www.sec.gov/rules/interp/2019/ia-5248.pdf; Jay Clayton, Chairman U.S. Sec. and Exch. Comm'n, Remarks at Meeting of the Investor Advisory Committee (Dec. 13, 2018) (*transcript available at* https://www.sec.gov/news/public-statement/clayton-remarks-investor-advisory-committee-meeting-121318).

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