

DOL Final Rule on Use of Financial Factors in Selecting Plan Investments

by Lori L. Shannon, Partner, Barnes & Thornburg, LLP

February 2021

The Department of Labor (DOL) has issued its Final Rule regarding the use of financial factors in selecting investments in plans subject to ERISA. The Final Rule clarifies certain provisions in the Proposed Rule.

The regulatory text of the Final Rule does not specifically refer to investments in environmental, social and governance (ESG) funds by retirement plan fiduciaries and participants. However, the explanatory comments issued with the Final Rule indicate that it is intended to apply to the use of ESG funds in ERISA plans.

The Final Rule clarifies certain duties of ERISA plan fiduciaries in selecting investment funds:

- The requirements to satisfy a fiduciary's duty of loyalty are simplified in the Final Rule. Fiduciary investment decisions "must be based only on pecuniary factors," and fiduciaries "may not subordinate the interests of participants and beneficiaries in their retirement income or financial benefits under the plan to other objectives." A pecuniary factor is a factor expected to have a "material effect on the risk and/or return of an investment."
- To satisfy the duty of prudence, a fiduciary must determine that an investment or investment course of action is "reasonably designed" to further the purposes of the plan. In this regard, the fiduciary must only consider investment alternatives that are "reasonably available under the circumstances." The fiduciary need not "scour the market" for investment alternatives.

This report is intended for the exclusive use of clients or prospective clients of Fiducient Advisors. The information contained herein is intended for the recipient, is confidential and may not be disseminated or distributed to any other person without the prior approval of Fiducient Advisors. Any dissemination or distribution is strictly prohibited. Information has been obtained from a variety of sources believed to be reliable though not independently verified. Any forecasts represent future expectations and actual returns, volatilities and correlations will differ from forecasts. This report does not represent a specific investment recommendation. Please consult with your advisor, attorney and accountant, as appropriate, regarding specific advice. Past performance does not indicate future performance and there is a possibility of a loss.

- Only “pecuniary factors” may be used to select plan investments, except when two investment alternatives are indistinguishable based on pecuniary factors. In such case, the “all things being equal” test still applies. This means a non-pecuniary factor may be used as tie-breaker if two funds are otherwise equal, which is “rare.” If a fiduciary uses a non-pecuniary factor as a “tie-breaker,” the fiduciary must document: (i) why they were unable to choose an investment based on pecuniary factors alone; (ii) how the selected investment compares to alternative investments with respect to: (a) considerations of portfolio diversification, (b) the liquidity and rate of return relative to cash flow requirements, and (c) the rate of return relative to funding objectives; and (iii) how the non-pecuniary factor is consistent with plan participants’ interest in retirement income or other financial benefits. Accordingly, a fiduciary must explain how an ESG fund serves the financial interest of the plan, without regard to any societal benefits of the ESG fund. Note that, in some instances, ESG factors may be pecuniary factors. The Final Rule does not require that a fiduciary provide documentation for a decision to rely on pecuniary ESG factors when selecting investment funds.
- Specific rules apply to the selection of investment alternatives made available under individual account plans. “When assembling, choosing or modifying an investment menu for participants’ investment choices, a fiduciary must evaluate the designated investment alternatives on the menu based solely on pecuniary factors, not subordinate the interests of participants to unrelated objectives, and not sacrifice investment return or take on additional investment risk to promote non-pecuniary objectives or goals.” Fiduciaries must conduct extensive due diligence when evaluating ESG funds for consideration as plan investments. In applying the “all things being equal” test, plan fiduciaries may consider the express demands or interests of plan Participants” as non-pecuniary factors to break a tie between two funds.
- The selection of qualified default investment alternatives (QDIAs) may not be based on non-pecuniary factors. An investment fund may not be used as a QDIA “if it, or any of its components, has investment objectives or goals or principal investment strategies that include, consider or indicate the use of one or more non-pecuniary factors.” Even if the investment fund could otherwise be selected as an investment alternative under the plan through the use of non-pecuniary factors in accordance with the Final Rule, it cannot be designated as the QDIA.

The Final Rule is generally effective January 12, 2021. However, fiduciaries have until April 30, 2022 to make changes to qualified default investment alternatives to comply with the Final Rule.

This article should not be construed as legal advice or legal opinion on any specific facts or circumstances. The contents are intended for general informational purposes only, and you are urged to consult your own lawyer on any specific legal questions you may have concerning your situation.

About the Author



Lori L. Shannon is a partner in Barnes & Thornburg's Chicago office and a member of the Corporate Department. Ms. Shannon focuses her practice on employee benefit and executive compensation matters. With over 23 years of experience, Ms. Shannon counsels private and public companies and tax-exempt entities on the design and implementation of employee benefit and executive compensation plans and arrangements.

Lori L. Shannon
Partner
Barnes & Thornburg, LLP