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DOL finalizes rule on selecting plan investments

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The Department of Labor (DOL) has finalized changes to its "investment duties" regulation for ERISA plan fiduciaries that select investments for employee benefit plans. Updates include one change to the regulation's existing safe harbor on the prudent selection of investments and a new rule establishing minimum requirements for fiduciaries to satisfy their duty of loyalty. The changes are generally effective for investments and monitoring decisions made after Jan. 12, 2021, but fiduciaries have until April 30, 2022, to make any necessary changes to a plan's qualified default investment alternatives (QDIAs).

Existing duty-of-prudence safe harbor

Since 1979, DOL's investment duties regulation has explained how fiduciaries can satisfy their duty of prudence when carrying out investment activities. The rule is a safe harbor, so fiduciaries that follow it are treated as satisfying their duty of prudence. The safe harbor generally is available if a fiduciary does the following:

- Determines that a particular investment is reasonably designed as part of the portfolio to further the plan's purposes, after weighing the investment's associated risk of loss and opportunity for gain (or other return)

- Considers the portfolio's diversification, liquidity and current return relative to the plan's anticipated cash flow needs, as well as the portfolio's projected return relative to the plan's funding objectives

New requirement to compare investment alternatives

The new rule makes one change to the duty-of-prudence safe harbor: When determining whether an investment alternative is reasonably designed to further the plan's purposes, the fiduciary must compare the investment's opportunity for gain with that of other "reasonably available investment alternatives with similar risks." The preamble explains that DOL doesn't expect fiduciaries to "scour the market or consider every possible alternative" — to the contrary, incurring the cost of such a search would be imprudent. DOL also acknowledges that fiduciaries could prudently conclude — and document — that an investment's characteristics and purpose are sufficiently rare that no alternatives with similar risks are reasonably available for this comparison.

New duty-of-loyalty requirements

The final rule adds new provisions on how fiduciaries satisfy their ERISA duty of loyalty when selecting plan investments. Unlike the prudence rules, these new duty-of-loyalty provisions are minimum standards for investment fiduciaries — not a safe harbor.

Focus on pecuniary factors

The new rule explicitly requires fiduciaries to base their decisions only on pecuniary factors, except in limited circumstances. Fiduciaries may not subordinate participants' interests under the plan to other objectives, or sacrifice investment return or take on additional risk to promote nonpecuniary goals. Under the rule, a pecuniary factor is one the fiduciary determines will likely have a material effect on an investment's risk and/or return, based on appropriate investment horizons consistent with the plan's investment objectives and funding policy.

Proprietary funds, fee sharing and fee aggregation. The proposed rule focused heavily on the need to evaluate potential risk and return when making investment decisions based on pecuniary factors. Some commenters noted that this could deter fiduciaries from engaging in common, accepted and generally beneficial practices, such as the use of proprietary products, fee sharing and fee aggregation. The preamble clarifies that the final rule neither prohibits nor permits these practices. However, fiduciaries must evaluate whether such practices are expected to have a material effect on risk and/or return compared with reasonably available alternatives.

Nonpecuniary factors can be deciding factors

Fiduciaries can use nonpecuniary factors as the deciding factor for an investment decision when pecuniary factors alone aren't sufficient to distinguish investment alternatives. However, fiduciaries using nonpecuniary factors must document the following:

- Why pecuniary factors were insufficient to make the investment decision

- How the selected investment compares to the alternatives
- How the deciding nonpecuniary factors are consistent with the interests of plan participants

Softening from proposal. The proposed rule would have let fiduciaries use nonpecuniary factors to break ties after determining that investment alternatives were "economically indistinguishable." Commenters disagreed about the meaning of that phrase and whether true ties actually exist. In response, DOL settled on a less stringent requirement that nonpecuniary factors may be used when the fiduciary can't distinguish between alternatives based on pecuniary factors alone, rather than when investment alternatives are identical in every respect (e.g., risk/return, fees, etc.). The preamble says this tie-breaking rule is available when the fiduciary prudently determines that the investment alternatives would serve equivalent roles in the plan's investment portfolio.

Additional considerations for individual account plans

The rule includes special provisions on selecting or retaining investment alternatives for individual account plans. When a plan offers a broad range of investment alternatives — as required for fiduciaries to have no liability for participants' investment decisions under ERISA Section 404(c) — fiduciaries aren't prohibited from including an investment that promotes or supports nonpecuniary goals. However, fiduciaries still must satisfy the prudence and loyalty requirements of the investment duties regulation, including the requirement to evaluate investments based solely on pecuniary factors.

Brokerage windows. The new loyalty provisions for individual account plans apply to the selection of "designated investment alternatives" — which are plan-designated funds into which participants can direct their investments. The definition specifically excludes brokerage windows, self-directed brokerage accounts and similar arrangements that let participants select investments beyond those designated by the plan. This means that the rule's pecuniary analysis doesn't apply to these arrangements. However, the preamble makes clear that ERISA's overarching duties of prudence and loyalty still apply to a fiduciary's decision to make these arrangements available, taking into account the nature and quality of the services provided by the arrangements.

Additional restrictions on QDIAs

A fund may not be added or retained as a component of a QDIA if the fund's objectives, goals or principal investment strategies consider or indicate the use of nonpecuniary factors.

Look to prospectus. In the preamble, DOL asserts that fiduciaries should easily be able to determine whether nonpecuniary factors are a material part of a fund's investment objectives by reviewing an investment alternative's prospectus or similar document.

Funds that use screening. DOL cautions against (but doesn't explicitly prohibit) selecting investment alternatives that screen companies based on nonpecuniary factors. Examples of such screening include excluding companies that produce weapons or fossil fuels, or including only companies that meet certain carbon emission or board diversity criteria. DOL believes screening raises the possibility that the fund manager is forgoing financial returns to further nonpecuniary goals. If a fund manager employs nonpecuniary factors in screening — and those exclusions are reflected in the fund's objectives, goals or principal investment strategy — then the fund can't be a QDIA.

Effective date with transition period for QDIAs

The final rule is effective Jan. 12, 2021, and applies to investments and investment decisions (including ongoing investment monitoring) made after the effective date. DOL will not enforce the final rule for investment actions taken before its effective date (and doesn't believe doing so would be viable). The rule gives fiduciaries until April 30, 2022, to replace QDIAs as necessary to comply with the new rules.

Focus shifts from ESG to nonpecuniary factors

The proposed rule included several provisions that specifically targeted the selection of funds that consider environmental, social or corporate governance (ESG) factors. For example, the proposed rule would have required fiduciaries of individual account plans to document the selection and monitoring process for funds that consider ESG goals, but not for funds with other nonpecuniary goals. The restrictions on funds as QDIAs also would have applied only to funds with ESG goals.

DOL has removed these ESG-specific provisions from the final rule and instead focused on pecuniary and nonpecuniary factors. This change avoids any suggestion that ESG funds are subject to stricter requirements than funds with other nonpecuniary goals or that ESG factors can never be pecuniary factors. The preamble clarifies that fiduciaries could prudently conclude that ESG factors are pecuniary factors — i.e., that ESG investment strategies may be financially beneficial to a plan. DOL also acknowledges several academic and financial studies that show sustainable funds can outperform less sustainable peers. However, DOL cautions fiduciaries against concluding too hastily that ESG factors are pecuniary. So a fiduciary will need to diligently follow the final rule's requirements when selecting an investment, basing the decision solely on factors the fiduciary prudently determines to be pecuniary.

Despite the final rule's slightly softer stance, DOL's concerns about ESG investing prompted the rule, and the agency remains decidedly cautious. However, fiduciaries hoping to invest in ESG funds may be comforted by the preamble's clarification that the proposal wasn't intended to condemn ESG investing, as some practitioners thought.

Related resources

Non-Mercer resources

- Final regulation (Federal Register, Nov. 13, 2020)
- Fact sheet (DOL, Oct. 30, 2020)
- Press release (DOL, Oct. 30, 2020)

Mercer Law & Policy resources

- DOL proposal would curtail social investing (July 7, 2020)

Other Mercer resources

- Responsible investment
- Mercer's ESG ratings
- Misperceptions and trends in ESG investing (Nov. 18, 2019)
- The ABC of ESG (Jan. 29, 2019)

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