

**DEPARTMENT OF LABOR****Employee Benefits Security Administration****29 CFR Parts 2509 and 2550**

RIN 1210-AB95

**Financial Factors in Selecting Plan Investments**

**AGENCY:** Employee Benefits Security Administration, Department of Labor.  
**ACTION:** Final rule.

**SUMMARY:** The Department of Labor (Department) is adopting amendments to the “investment duties” regulation under Title I of the Employee Retirement Income Security Act of 1974, as amended (ERISA). The amendments require plan fiduciaries to select investments and investment courses of action based solely on financial considerations relevant to the risk-adjusted economic value of a particular investment or investment course of action.

**DATES:** The final rule is effective on January 12, 2021.

**FOR FURTHER INFORMATION CONTACT:** Jason A. DeWitt, Office of Regulations and Interpretations, Employee Benefits Security Administration, (202) 693-8500. This is not a toll-free number.

**Customer Service Information:** Individuals interested in obtaining information from the Department of Labor concerning ERISA and employee benefit plans may call the Employee Benefits Security Administration (EBSA) Toll-Free Hotline, at 1-866-444-EBSA (3272) or visit the Department of Labor’s website ([www.dol.gov/ebsa](http://www.dol.gov/ebsa)).

**SUPPLEMENTARY INFORMATION:****A. Background**

Title I of the Employee Retirement Income Security Act of 1974 (ERISA) establishes minimum standards that govern the operation of private-sector employee benefit plans, including fiduciary responsibility rules. Section 404 of ERISA, in part, requires that plan fiduciaries act prudently and diversify plan investments so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so. Sections 403(c) and 404(a) also require fiduciaries to act solely in the interest of the plan’s participants and beneficiaries, and for the exclusive purpose of providing benefits to participants and beneficiaries and defraying reasonable expenses of administering the plan.

Courts have interpreted the exclusive purpose rule of ERISA section

404(a)(1)(A) to require fiduciaries to act with “complete and undivided loyalty to the beneficiaries,”<sup>1</sup> observing that their decisions must “be made with an eye single to the interests of the participants and beneficiaries.”<sup>2</sup> The Supreme Court as recently as 2014 unanimously held in the context of ERISA retirement plans that such interests must be understood to refer to “*financial*” rather than “*nonpecuniary*” benefits,<sup>3</sup> and Federal appellate courts have described ERISA’s fiduciary duties as “the highest known to the law.”<sup>4</sup> The Department’s longstanding and consistent position, reiterated in multiple forms of sub-regulatory guidance, is that when making decisions on investments and investment courses of action, plan fiduciaries must be focused solely on the plan’s financial returns, and the interests of plan participants and beneficiaries in their benefits must be paramount.

The Department has been asked periodically over the last 30 years to consider the application of these principles to pension plan investments selected because of the non-pecuniary benefits they may further, such as those relating to environmental, social, and corporate governance considerations. Various terms have been used to describe this and related investment behaviors, such as socially responsible investing, sustainable and responsible investing, environmental, social, and corporate governance (ESG) investing, impact investing, and economically targeted investing. The terms do not have a uniform meaning and the terminology is evolving.<sup>5</sup>

The Department’s first comprehensive guidance addressing these types of investment issues was in Interpretive Bulletin 94-1 (IB 94-1).<sup>6</sup> There, the

<sup>1</sup> *Donovan v. Mazzola*, 716 F.2d 1226, 1238 (9th Cir. 1983) (quoting *Freund v. Marshall & Ilsley Bank*, 485 F. Supp. 629, 639 (W.D. Wis. 1979)).

<sup>2</sup> *Donovan v. Bierwirth*, 680 F.2d 263, 271 (2d Cir. 1982).

<sup>3</sup> *Fifth Third Bancorp v. Dudenhoeffer*, 573 U.S. 409, 421 (2014) (the “benefits” to be pursued by ERISA fiduciaries as their “exclusive purpose” does not include “nonpecuniary benefits”) (emphasis in original).

<sup>4</sup> See, e.g., *Tibble v. Edison Int’l*, 843 F.3d 1187, 1197 (9th Cir. 2016).

<sup>5</sup> For a concise history of the current ESG movement and the evolving terminology, see Max Schanzenbach & Robert Sitkoff, *Reconciling Fiduciary Duty and Social Conscience: The Law and Economics of ESG Investing by a Trustee*, 72 *Stan. L. Rev.* 381, 392-97 (2020).

<sup>6</sup> 59 FR 32606 (June 23, 1994) (appeared in Code of Federal Regulations as 29 CFR 2509.94-1).

Interpretive Bulletins are a form of sub-regulatory guidance that are published in the **Federal Register** and included in the Code of Federal Regulations. Prior to issuing IB 94-1, the Department had issued a number of letters concerning a fiduciary’s ability to consider the non-pecuniary effects of an

term used was “economically targeted investments” (ETIs). The Department’s objective in issuing IB 94-1 was to state that ETIs<sup>7</sup> are not inherently incompatible with ERISA’s fiduciary obligations. The preamble to IB 94-1 explained that the requirements of sections 403 and 404 of ERISA do not prevent plan fiduciaries from investing plan assets in ETIs if the investment has an expected rate of return commensurate to rates of return of available alternative investments with similar risk characteristics, and if the investment vehicle is otherwise an appropriate investment for the plan in terms of such factors as diversification and the investment policy of the plan. Some commentators have referred to this as the “all things being equal” test or the “tie-breaker” standard. The Department stated in the preamble to IB 94-1 that when competing investments serve the plan’s economic interests equally well, plan fiduciaries can use such non-pecuniary considerations as the deciding factor for an investment decision.

investment and granted a variety of prohibited transaction exemptions to both individual plans and pooled investment vehicles involving investments that produce non-pecuniary benefits. See Advisory Opinions 80-33A, 85-36A and 88-16A; Information Letters to Mr. George Cox, dated Jan. 16, 1981; to Mr. Theodore Groom, dated Jan. 16, 1981; to The Trustees of the Twin City Carpenters and Joiners Pension Plan, dated May 19, 1981; to Mr. William Chadwick, dated July 21, 1982; to Mr. Daniel O’Sullivan, dated Aug. 2, 1982; to Mr. Ralph Katz, dated Mar. 15, 1982; to Mr. William Ecklund, dated Dec. 18, 1985, and Jan. 16, 1986; to Mr. Reed Larson, dated July 14, 1986; to Mr. James Ray, dated July 8, 1988; to the Honorable Jack Kemp, dated Nov. 23, 1990; and to Mr. Stuart Cohen, dated May 14, 1993; PTE 76-1, part B, concerning construction loans by multiemployer plans; PTE 84-25, issued to the Pacific Coast Roofers Pension Plan; PTE 85-58, issued to the Northwestern Ohio Building Trades and Employer Construction Industry Investment Plan; PTE 87-20, issued to the Racine Construction Industry Pension Fund; PTE 87-70, issued to the Dayton Area Building and Construction Industry Investment Plan; PTE 88-96, issued to the Real Estate for American Labor A Balcor Group Trust; PTE 89-37, issued to the Union Bank; and PTE 93-16, issued to the Toledo Roofers Local No. 134 Pension Plan and Trust, et al. In addition, one of the first directors of the Department’s benefits office authored an influential article on this topic in 1980. See Ian D. Lanoff, *The Social Investment of Private Pension Plan Assets: May It Be Done Lawfully Under ERISA?*, 31 *Labor L.J.* 387, 391-92 (1980) (stating that “[t]he Labor Department has concluded that economic considerations are the only ones which can be taken into account in determining which investments are consistent with ERISA standards,” and warning that fiduciaries who exclude investment options for non-economic reasons would be “acting at their peril”).

<sup>7</sup> IB 94-1 used the terms ETI and economically targeted investments to broadly refer to any investment or investment course of action that is selected, in part, for its expected non-pecuniary benefits, apart from the investment return to the employee benefit plan investor.

Since 1994, the Department's sub-regulatory guidance has gone through an iterative process, but the Department's emphasis on the primacy of plan participants' economic interests has stayed constant. In 2008, the Department replaced IB 94-1 with Interpretive Bulletin 2008-01 (IB 2008-01).<sup>8</sup> In 2015, the Department replaced IB 2008-01 with Interpretive Bulletin 2015-01 (IB 2015-01),<sup>9</sup> which is codified at 29 CFR 2509.2015-01. Each Interpretive Bulletin has consistently stated that the paramount focus of plan fiduciaries must be the plan's financial returns and providing promised benefits to participants and beneficiaries. The Department has construed the requirements that a fiduciary act solely in the interest of, and for the exclusive purpose of providing benefits to, participants and beneficiaries as prohibiting a fiduciary from subordinating the interests of participants and beneficiaries in their retirement income to unrelated objectives. Thus, each Interpretive Bulletin, while restating the "all things being equal" test, also cautioned that fiduciaries violate ERISA if they accept reduced expected returns or greater risks to secure social, environmental, or other policy goals.

The preamble to IB 2015-01 explained that if a fiduciary prudently determines that an investment is appropriate based solely on economic considerations, including those that may derive from ESG factors, the fiduciary may make the investment without regard to any collateral benefits the investment may also promote. In 2018, the Department clarified in Field Assistance Bulletin 2018-01 (FAB 2018-01) that IB 2015-01 had merely recognized that there could be instances when ESG issues present material business risk or opportunities to companies that company officers and directors need to manage as part of the company's business plan, and that qualified investment professionals would treat the issues as material economic considerations under generally accepted investment theories. As appropriate economic considerations, they should be considered by a prudent fiduciary along with other relevant economic factors to evaluate the risk and return profiles of alternative investments. In other words, in these instances the factors are not "tie-breakers," but pecuniary (or "risk-return") factors affecting the economic merits of the investment.

The Department cautioned, however, that "[t]o the extent ESG factors, in fact, involve business risks or opportunities that are properly treated as economic considerations themselves in evaluating alternative investments, the weight given to those factors should also be appropriate to the relative level of risk and return involved compared to other relevant economic factors."<sup>10</sup> The Department further emphasized in FAB 2018-01 that fiduciaries "must not too readily treat ESG factors as economically relevant to the particular investment choices at issue when making a decision," as "[i]t does not ineluctably follow from the fact that an investment promotes ESG factors, or that it arguably promotes positive general market trends or industry growth, that the investment is a prudent choice for retirement or other investors." Rather, ERISA fiduciaries must always put first the economic interests of the plan in providing retirement benefits and "[a] fiduciary's evaluation of the economics of an investment should be focused on financial factors that have a material effect on the return and risk of an investment based on appropriate investment horizons consistent with the plan's articulated funding and investment objectives."<sup>11</sup>

## B. Purpose of Regulatory Action

Available research and data show a steady upward trend in use of the term "ESG" among institutional asset managers, an increase in the array of ESG-focused investment vehicles available, a proliferation of ESG metrics, services, and ratings offered by third-party service providers, and an increase in asset flows into ESG funds. This trend has been underway for many years, but recent studies indicate the trajectory is accelerating. For example, according to Morningstar, the assets invested in sustainable funds was nearly four times larger in 2019 than in 2018.<sup>12</sup>

<sup>10</sup> Field Assistance Bulletin 2018-01 (Apr. 23, 2018).

<sup>11</sup> Id.

<sup>12</sup> See Jon Hale, *The ESG Fund Universe Is Rapidly Expanding* (March 19, 2020), [www.morningstar.com/articles/972860/the-esg-fund-universe-is-rapidly-expanding](http://www.morningstar.com/articles/972860/the-esg-fund-universe-is-rapidly-expanding). This trend is most pronounced in Europe, where authorities are actively promoting consideration of ESG factors in investing. See, e.g., Principles for Responsible Investment (PRI), *Fiduciary Duty in the 21st Century* (Oct. 2019), [www.unpri.org/download?ac=9792](http://www.unpri.org/download?ac=9792), at 34-35 (quoting official from EU securities regulator that "ESG is part of [their] core mandate."); Emre Peker, *What Qualifies as a Green Investment? EU Sets Rules*, Wall Street Journal (Dec. 17, 2019), [www.wsj.com/articles/eu-seals-deal-to-create-regulatory-benchmark-for-green-finance-11576595600](http://www.wsj.com/articles/eu-seals-deal-to-create-regulatory-benchmark-for-green-finance-11576595600) ("European officials have been racing to set the global benchmark for

As ESG investing has increased, it has engendered important and substantial questions with numerous observers identifying a lack of precision and consistency in the marketplace with respect to defining ESG investments and strategies, as well as shortcomings in the rigor of the prudence and loyalty analysis by some participating in the ESG investment marketplace.<sup>13</sup> There is no consensus about what constitutes a genuine "ESG" investment, and ESG rating systems are often vague and inconsistent, despite featuring prominently in marketing efforts.<sup>14</sup> The use of terms such as ESG, impact investing, sustainability, and non-financial performance metrics, among others, encompass a wide variety of considerations without a common nexus and can take on different meanings to different people. In part, the confusion stems from the fact that, from its beginning, the ESG investing movement has had multiple goals, both pecuniary

green finance"); Principles for Responsible Investment, *Investor priorities for the EU Green Deal* (April 30, 2020), [www.unpri.org/sustainable-markets/investor-priorities-for-the-eu-green-deal/5710.article](http://www.unpri.org/sustainable-markets/investor-priorities-for-the-eu-green-deal/5710.article) (discussing proposal to require ESG data to be disclosed alongside traditional elements of corporate and financial reporting, including a core set of mandatory ESG key performance indicators).

<sup>13</sup> See, e.g., *OECD Business and Finance Outlook 2020* (Sept. 2020), [www.oecd.org/daf/oeceb-business-and-finance-outlook-26172577.htm](http://www.oecd.org/daf/oeceb-business-and-finance-outlook-26172577.htm), at 29 ("The review of academic and industry literature reveals a wide range of approaches and results, which are largely inconsistent with one another. The research highlights the difficulty of identifying the real impact of ESG on investment performance."); *Scarlet Letters: Remarks of SEC Commissioner Hester M. Peirce before the American Enterprise Institute* (June 18, 2019), [www.sec.gov/news/speech/speech-peirce-061819](http://www.sec.gov/news/speech/speech-peirce-061819); Paul Brest, Ronald J. Gilson, & Mark A. Wolfson, *How Investors Can (and Can't) Create Social Value*, European Corporate Governance Institute, Law Working Paper No. 394 (Mar. 29, 2018), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3150347](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3150347), at 5; Ogechukwu Ezeokoli et al., *Environmental, Social, and Governance (ESG) Investment Tools: A Review of the Current Field* (Dec. 2017), [www.dol.gov/sites/dolgov/files/OASP/legacy/files/ESG-Investment-Tools-Review-of-the-Current-Field.pdf](http://www.dol.gov/sites/dolgov/files/OASP/legacy/files/ESG-Investment-Tools-Review-of-the-Current-Field.pdf), at 11-13.

<sup>14</sup> See, e.g., *OECD Business and Finance Outlook 2020* (Sept. 2020), at 26-33, 47-58; Feifei Li & Ari Polychronopoulos, *What a Difference an ESG Ratings Provider Makes!* (Jan. 2020), [www.researchaffiliates.com/documents/770-what-a-difference-an-esg-ratings-provider-makes.pdf](http://www.researchaffiliates.com/documents/770-what-a-difference-an-esg-ratings-provider-makes.pdf); Florian Berg, Julian Kölbl, & Roberto Rigobon, *Aggregate Confusion: The Divergence of ESG Ratings* (Aug. 2019), MIT Sloan Research Paper No. 5822-19, <https://ssrn.com/abstract=3438533>; Schroders, *2018 Annual Sustainable Investment Report* (March 2019), [www.schroders.com/en/insights/economics/annual-sustainable-investment-report-2018](http://www.schroders.com/en/insights/economics/annual-sustainable-investment-report-2018), at 22-23 (majority of passive ESG funds rely on a single third party ESG rating provider that "typically emphasize tick-the-box policies and disclosure levels, data points unrelated to investment performance and/or backward-looking negative events with little predictive power").

<sup>8</sup> 73 FR 61734 (Oct. 17, 2008).

<sup>9</sup> 80 FR 65135 (Oct. 26, 2015).

and non-pecuniary.<sup>15</sup> Moreover, ESG funds often come with higher fees, because additional investigation and monitoring are necessary to assess an investment from an ESG perspective.<sup>16</sup>

The Securities and Exchange Commission (SEC) has also undertaken initiatives related to ESG. The examination priorities of the Securities and Exchange Commission (SEC) for 2020 include a particular interest in the accuracy and adequacy of disclosures provided by registered investment advisers offering clients new types or emerging investment strategies, such as strategies focused on sustainable and responsible investing, which incorporate ESG criteria.<sup>17</sup> The SEC also solicited public comment on the appropriate treatment for funds that use terms such as “ESG” in their name and whether these terms are likely to mislead investors.<sup>18</sup>

ESG investing raises heightened concerns under ERISA. Public companies and their investors may legitimately pursue a broad range of objectives, subject to the disclosure requirements and other requirements of the securities laws. Pension plans and other benefit plans covered by ERISA, however, are bound by statute to a narrower objective: Prudent management with an “eye single” to maximizing the funds available to pay benefits under the plan.<sup>19</sup> Providing a secure retirement for American workers is the paramount, and eminently

worthy, “social” goal of ERISA plans; plan assets may never be enlisted in pursuit of other social or environmental objectives at the expense of ERISA’s fundamental purpose of providing secure and valuable retirement benefits.

Section 404(a)(1)(A) of ERISA expressly requires that plan fiduciaries act “for the exclusive purpose of: (i) Providing benefits to participants and their beneficiaries; and (ii) defraying reasonable expenses of administering the plan.” The Department is concerned, however, that the growing emphasis on ESG investing may prompt ERISA plan fiduciaries to make investment decisions for purposes distinct from providing benefits to participants and beneficiaries and defraying reasonable expenses of administering the plan. The Department is also concerned that some investment products may be marketed to ERISA fiduciaries on the basis of purported benefits and goals unrelated to financial performance.<sup>20</sup> For example, the Department understands that the fund managers of some ESG investment funds offered to ERISA defined contribution plans represent that the fund is appropriate for ERISA plan investment platforms, while acknowledging in disclosure materials that the fund may perform differently, forgo investment opportunities, or accept different investment risks, in order to pursue the ESG objectives.

This regulatory project was undertaken in part to make clear that ERISA plan fiduciaries may not subordinate return or increase risks to promote non-pecuniary objectives. The duty of loyalty—a bedrock principle of ERISA, with deep roots in the common law of trusts—requires those serving as fiduciaries to act with a single-minded focus on the interests of beneficiaries.<sup>21</sup> The duty of prudence prevents a

fiduciary from choosing an investment alternative that is financially less beneficial than reasonably available alternatives. These fiduciary standards are the same no matter the investment vehicle or category.

The Department believes that confusion with respect to these investment requirements persists, perhaps due in part to varied statements the Department has made on the use of non-pecuniary or non-financial factors over the years in sub-regulatory guidance. Accordingly, the Department intends, by this final regulation, to promulgate principles of fiduciary standards for selecting and monitoring investments, and set forth the scope of fiduciary duties surrounding non-pecuniary issues. Under the final rule, plan fiduciaries, when making decisions on investments and investment courses of action, must focus solely on the plan’s financial risks and returns and keep the interests of plan participants and beneficiaries in their plan benefits paramount. The fundamental principle is that an ERISA fiduciary’s evaluation of plan investments must be focused solely on economic considerations that have a material effect on the risk and return of an investment based on appropriate investment horizons, consistent with the plan’s funding policy and investment policy objectives. The corollary principle is that ERISA fiduciaries must never sacrifice investment returns, take on additional investment risk, or pay higher fees to promote non-pecuniary benefits or goals.

The final rule recognizes that there are instances where one or more environmental, social, or governance factors will present an economic business risk or opportunity that corporate officers, directors, and qualified investment professionals would appropriately treat as material economic considerations under generally accepted investment theories. For example, a company’s improper disposal of hazardous waste would likely implicate business risks and opportunities, litigation exposure, and regulatory obligations. Dysfunctional corporate governance can likewise present pecuniary risk that a qualified investment professional would appropriately consider on a fact-specific basis.

The purpose of this action is to set forth a regulatory structure to assist ERISA fiduciaries in navigating these ESG investment trends and to separate the legitimate use of risk-return factors from inappropriate investments that sacrifice investment return, increase costs, or assume additional investment

<sup>15</sup> See, e.g., *Who Cares Wins: Connecting Financial Markets to a Changing World* (2004), [www.unepfi.org/fileadmin/events/2004/stocks/who\\_cares\\_wins\\_global\\_compact\\_2004.pdf](http://www.unepfi.org/fileadmin/events/2004/stocks/who_cares_wins_global_compact_2004.pdf), at v. (“Overall goals” include “[s]tronger and more resilient financial markets” and “[c]ontribution to sustainable development”).

<sup>16</sup> See, e.g., Principles for Responsible Investment, *How Can a Passive Investor Be a Responsible Investor?* (Aug. 2019), [www.unpri.org/download?ac=6729](http://www.unpri.org/download?ac=6729), at 15 (ESG passive investing strategies likely result in higher fees compared to standard passive funds); Wayne Winegarden, *ESG Investing: An Evaluation of the Evidence*, Pacific Research Institute (May 2019), [www.pacificresearch.org/wp-content/uploads/2019/05/ESG\\_Funds\\_F\\_web.pdf](http://www.pacificresearch.org/wp-content/uploads/2019/05/ESG_Funds_F_web.pdf), at 11–12 (finding average expense ratio of 69 basis points for ESG funds compared to 9 basis points for broad-based S&P 500 index fund). In recent years, the asset-weighted expense ratio for ESG funds has decreased as ESG funds with lower expense ratios have attracted more fund flows than ESG funds with higher expense ratios. See Elisabeth Kashner, *ETF Fee War Hits ESG and Active Management* (Jan. 22, 2020), <https://insight.factset.com/etf-fee-war-hits-esg-and-active-management>.

<sup>17</sup> See Office of Compliance Inspections and Examinations, U.S. Securities and Exchange Commission, *2020 Examination Priorities*, at 15, [www.sec.gov/about/offices/ocie/national-examination-program-priorities-2020.pdf](http://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2020.pdf).

<sup>18</sup> See Request for Comment on Fund Names, Release No. IC-33809 (Mar. 2, 2020) (85 FR 13221 (Mar. 6, 2020)).

<sup>19</sup> *Donovan v. Bierwirth*, supra note 2, 680 F.2d at 271.

<sup>20</sup> See, e.g., James MacKintosh, *A User’s Guide to the ESG Confusion*, Wall Street Journal (Nov. 12, 2019), [www.wsj.com/articles/a-users-guide-to-the-esg-confusion-11573563604](http://www.wsj.com/articles/a-users-guide-to-the-esg-confusion-11573563604) (“It’s hard to move in the world of investment without being bombarded by sales pitches for running money based on ‘ESG’”); Mark Miller, *Bit by Bit, Socially Conscious Investors Are Influencing 401(k)’s*, New York Times (Sept. 27, 2019), [www.nytimes.com/2019/09/27/business/esg-401k-investing-retirement.html](http://www.nytimes.com/2019/09/27/business/esg-401k-investing-retirement.html).

<sup>21</sup> See Unif. Prudent Inv. Act section 5 cmt. (1995) (“The duty of loyalty is perhaps the most characteristic rule of trust law.”); see also Susan N. Gary, George G. Bogert, & George T. Bogert, *The Law of Trusts and Trustees: A Treatise Covering the Law Relating to Trusts and Allied Subjects Affecting Trust Creation and Administration* section 543 (3d ed. 2019) (quoting Justice Cardozo’s classic statement in *Meinhard v. Salmon*, 249 N.Y. 458, 464 (1928) that “[a] trustee is held to something stricter than morals of the market place. . . . Uncompromising rigidity has been the attitude of the courts of equity when petitioned to undermine the rule of undivided loyalty.”).

risk to promote non-pecuniary benefits or objectives. The Department believes that addressing these issues in the form of a notice and comment regulation will help safeguard the interests of participants and beneficiaries in the plan benefits.

### C. June 2020 Proposed Rule

In June 2020 (85 FR 39113 (June 30, 2020)), the Department published in the **Federal Register** a proposed rule to amend the “investment duties” regulation under Title I of the Employee Retirement Income Security Act of 1974, as amended (ERISA), to confirm that ERISA requires plan fiduciaries to select investments and investment courses of action based solely on financial considerations relevant to the risk-adjusted economic value of a particular investment or investment course of action. The proposal was intended to provide regulatory guideposts for plan fiduciaries in light of recent trends involving ESG investing that the Department is concerned may lead ERISA plan fiduciaries to choose investments or investment courses of action to promote environmental, social, and other public policy goals unrelated to the interests of plan participants and beneficiaries in receiving financial benefits from the plan, and expose plan participants and beneficiaries to inappropriate investment risks or lower returns than reasonably available investment alternatives. The proposal retained the core principles in the current regulation that set forth requirements for satisfying the prudence duty under ERISA section 404(a)(1)(B) when deciding on plan investments and investment courses of action.

The proposal suggested five major additions to the investment duties regulation. First, the proposal included new regulatory text that would require plan fiduciaries to select investments and investment courses of action based on financial considerations relevant to the risk-adjusted economic value of a particular investment or investment course of action. Second, the proposal added an express statement that compliance with the exclusive purpose (loyalty) duty in ERISA section 404(a)(1)(A) prohibits fiduciaries from subordinating the interests of plan participants and beneficiaries in retirement income and financial benefits to non-pecuniary goals. Third, a proposed new provision required fiduciaries to consider other available investments to meet their prudence and loyalty duties under ERISA. Fourth, the proposal acknowledged that ESG factors can be pecuniary factors, but only if they present economic risks or

opportunities that qualified investment professionals would treat as material economic considerations under generally accepted investment theories. The proposal added new regulatory text, setting forth required investment analysis and documentation requirements in the rare circumstances when fiduciaries are choosing among truly “indistinguishable” investments (related to the so-called “tie breaker rule”). The documentation requirement was intended to prevent fiduciaries from improperly finding economic equivalence and making decisions based on non-pecuniary benefits without a proper analysis and evaluation. Fiduciaries already commonly document and maintain records about their investment selections. The provision in the proposal would have made that general practice required where a fiduciary determines that alternative investment options are economically indistinguishable and where the fiduciary chooses one of the investments on the basis of a non-pecuniary factor. Fifth, the proposal added a new provision on selecting designated investment alternatives for a defined contribution individual account plan (commonly referred to as 401(k)-type plans). The proposal reiterated the Department’s view that the prudence and loyalty standards set forth in ERISA apply to a fiduciary’s selection of an investment alternative to be offered to plan participants and beneficiaries in a defined contribution individual account plan. The proposal described the requirements for the selection of investment alternatives for such plans that purport to pursue one or more environmental, social, and corporate governance-oriented objectives in their investment mandates or that include such parameters in the fund name.

Overall, the proposed rule was designed to assist fiduciaries in carrying out their responsibilities, while promoting the financial interests of current and future retirees. The Department acknowledged in the proposal that some plans would have to modify their processes for selecting and monitoring investments—in particular, plans whose current document and recordkeeping practices were insufficient to meet the proposal’s requirements.

The Department invited interested persons to submit comments on the proposed rule. In response to this invitation, the Department received more than 1,100 written comments submitted during the open comment period, and more than 7,600 submissions made as part of six separate petitions (*i.e.*, form letters). These

comments and petitions came from a variety of parties, including plan sponsors and other plan fiduciaries, individual plan participants and beneficiaries, financial services companies, academics, elected government officials, trade and industry associations, and others, both in support of and in opposition to the proposed rule. These comments were available for public review on the “Public Comments” page under the “Laws and Regulations” tab of the Department’s Employee Benefits Security Administration website.<sup>22</sup>

Many comments submitted on the proposal offered general support for, or opposition to, the Department’s proposal. These comments did not contain specific or detailed arguments on provisions of the proposal or otherwise include relevant, empirical information in the form of data or cited studies. As such, the Department does not separately identify or discuss these general comments in this document, although the preamble, in its entirety, addresses the reasons for undertaking this regulatory initiative and the rationales for the Department’s specific regulatory choices.

Some commenters asserted that the proposal was “unsupported by substantial evidence” and was “unwarranted by the facts,” does not meet the minimum requirements of the Administrative Procedure Act, the Paperwork Reduction Act, or Executive order and Office of Management and Budget guidelines on cost-benefit analysis, and argued that the proposal could not withstand legal challenge in court. Several commenters argued for withdrawal of the proposed rule stating that the proposal neither demonstrated a compelling need for regulatory action nor demonstrated any fiduciary action that was injurious to plans. Some additionally argued that the Department had failed to employ the least burdensome method to effect any necessary change or to present any empirical data or evidence of a problem that justified the regulation. The Department, the commenters asserted, failed to provide a single example of any ERISA fiduciary allocating any investment on the basis of non-pecuniary criteria or any investigations or enforcement activity based on these concerns.

<sup>22</sup> See [www.dol.gov/agencies/ebsa/laws-and-regulations/rules-and-regulations/public-comments/1210-AB95](http://www.dol.gov/agencies/ebsa/laws-and-regulations/rules-and-regulations/public-comments/1210-AB95). The Department received some comment letters on the proposed rule that were submitted after the close of the comment period. Those late comments were not considered or posted on the Department’s website.

Other commenters indicated that current guidance is sufficient to enable the Department to bring enforcement actions against fiduciaries who fail to meet their responsibilities. Further, they asserted, the regulation was not proposed pursuant to either an explicit statutory mandate or evidence of an actual documented problem. Some commenters responded to the Department's observation of the growing emphasis on ESG in the marketplace by arguing that the more frequent use of the term "ESG" does not indicate any improper fiduciary decision making. Some also argued that the Department's approach is incongruent with that of other regulators who require consideration of financially material ESG factors and focus on the importance of disclosure of those factors.

With respect to the arguments of commenters concerning the Administrative Procedure Act, the Department believes that there are sufficient reasons to justify the promulgation of this final rule, including the lack of precision and consistency in the marketplace with respect to defining ESG investments and strategies, shortcomings in the rigor of the prudence and loyalty analysis by some participating in the ESG investment marketplace, and perceived variation in some aspects of the Department's past guidance on the extent a fiduciary may consider non-pecuniary factors in making investment decisions. Further, the iterative Interpretive Bulletins since 1994, followed by the Field Assistance Bulletin issued in 2018, and the number of advisory opinions and information letters historically issued on this topic demonstrate the need for notice and comment guidance issued under the Administrative Procedure Act.<sup>23</sup> The Department does not believe that there needs to be specific evidence of fiduciary misbehavior or demonstrated injury to plans and plan participants in order to issue a regulation addressing the application of ERISA's fiduciary duties to the issue of investing for non-pecuniary benefits. The need for this regulation was also demonstrated by some commenters who indicated their intention to make, or current practice in making, plan investment decisions based on non-pecuniary factors, rather than based on investment risk and return. For example, some commenters claimed that ERISA fiduciaries must prioritize the long-term, absolute returns for "universal owners," and that

collective investor action to manage social and environmental systems is necessary. As another example, other commenters argued that fiduciaries should be permitted to consider the potential for an investment to create jobs for workers who in turn would participate in the plan. These comments signal that the Department needs to address the use of non-pecuniary factors by fiduciaries when making decisions about ERISA plan investments and investment courses of action. Under the Department's authority to administer ERISA, the Department may promulgate rules that are preemptive in nature and is not required to wait for widespread harm to occur. The Department can ensure that demonstrated injury to plans and plan participants and beneficiaries are protected prospectively. Investing for non-pecuniary objectives raises heightened concerns under ERISA.

As the Department noted in the proposal, public companies and their investors may legitimately and properly pursue a broad range of objectives, subject to the disclosure requirements and other requirements of the securities laws. However, fiduciaries of pension and other benefit plans covered by ERISA are statutorily bound to manage those plans with a singular goal of maximizing the funds available to pay benefits under the plan. Indeed, the final rule furthers the paramount goal of ERISA plans to provide a secure retirement for American workers, and states that plans may not forego investment opportunities or assume investment risk to promote other non-financial goals.<sup>24</sup> In response to comments stating that the current guidance is sufficient, the Department believes that there is a reasonable need for this rulemaking, for the reasons explained earlier. The Department also believes that proceeding through notice-and-comment rulemaking rather than promulgating further interpretive guidance has other benefits, including the benefit of public input and the greater stability of codified rules. Proceeding in this manner is also consistent with the principles of Executive Order 13891 and the

Department's recently issued PRO Good Guidance rule, which emphasize the importance of public participation, fair notice, and compliance with the Administrative Procedure Act.<sup>25</sup>

Some commenters complained that the 30-day comment period was too short given the complexity of the proposed changes, the magnitude of such changes to the retirement marketplace, and the need to prepare supporting data. They stated that those challenges were exacerbated by the present COVID-19 pandemic. Many commenters requested an extension of the comment period and that the Department schedule a public hearing on the proposal and allow the public record to remain open for post-hearing comments from interested parties. The Department has considered these requests, but has determined that it is neither necessary nor appropriate to extend the public comment period, hold a public hearing, or withdraw or republish the proposed regulation. A substantial and comprehensive public comment record was developed on the proposal sufficient to substantiate promulgating a final rule. The scope and depth of the public record that has been developed itself belies arguments that a 30-day comment period was insufficient. In addition, most issues relevant to the proposal have been analyzed and reviewed by the Department and the public in the context of three separate Interpretive Bulletins issued in 1994, 2008, and 2015 and the public feedback that resulted.<sup>26</sup> Finally, public hearings are not required under the Department's general rulemaking authority under section 505 of ERISA, nor under the Administrative Procedure Act's procedures for rulemaking at 5 U.S.C. 553(c). In this case, a public hearing is not necessary to supplement an already comprehensive public record.

Thus, this final rulemaking follows the notice and comment process required by the Administrative Procedure Act, and fulfills the Department's mission to protect, educate, and empower retirement investors as they face important choices

<sup>24</sup> Executive Order 13868 on Promoting Energy Infrastructure and Economic Growth directed the Department to complete a review of available data filed with the Department in order to identify whether there are discernible trends with respect to plan investments in the energy sector. The order also required the Department to provide an update to the Assistant to the President for Economic Policy on any discernible trends in energy investments by such plans and to complete a review of existing Department of Labor guidance on the fiduciary responsibilities for proxy voting. Nothing in the order dealt with investing for non-pecuniary purposes. As a result, no reports related to the proposal were required by the Executive order.

<sup>25</sup> See 85 FR 53163 (Aug. 28, 2020) (promulgating the Department's rule on promoting regulatory openness through good guidance).

<sup>26</sup> Further, the Department has also considered this subject in the context of specific questions submitted by stakeholders since the 1980s. See, e.g., DOL Inf. Ltr. to George Cox (Jan. 16, 1981); DOL Adv. Op. to Theodore R. Groom (Jan. 16, 1981); DOL Adv. Op. to Daniel E. O'Sullivan, Union Labor Life Ins. Co (Aug. 2, 1982); Ltr from Ass't Sec. Dennis Kass to Sen. Howard Metzenbunam (May 27, 1985); DOL Adv. Op. to James Ray, Union Labor Life Ins. Co. (July 8, 1988); DOL Inf. Ltr. to Stuart Cohen, General Motors Corp. (May 14, 1993).

<sup>23</sup> See Executive Order 13891, 84 FR 55235 (Oct. 15, 2019) promoting notice and comment regulation for guidance.

in saving for retirement in their employee benefit plans. This rule is considered to be an Executive Order (E.O.) 13771 regulatory action. Details on the estimated costs of this rule can be found in the final rule's economic analysis. The Department concluded that the additions to § 2550.404a-1 (404a-1 regulation) and the rule's improvements to the Department's previous sub-regulatory guidance are appropriate and warranted. Accordingly, after consideration of the written comments received, the Department has determined to adopt the proposed regulation as modified and set forth below.

#### D. The Final Rule

The final regulation sets forth fiduciary standards for selecting and monitoring investments held by ERISA plans, and addresses the scope of fiduciary duties surrounding non-pecuniary issues. The final regulation contains several important changes from the proposal in response to public comments. The fact that the loyalty principles of section 404(a)(1)(A) of ERISA are now coupled with the previous prudence regulation under section 404(a)(1)(B) confirms that, in making investment decisions of any kind, ERISA requires that both the principles of loyalty and of prudence must be considered. The final rule expressly applies these principles not just to investments and investment courses of action, but also to the selection of available investment options for plan participants in individual account plans.

As more fully described below, the final rule makes five major amendments to the investment duties regulation under Title I of ERISA at 29 CFR 2550.404a-1. First, the final rule adds provisions to confirm that ERISA fiduciaries must evaluate investments and investment courses of action based solely on pecuniary factors—financial considerations that have a material effect on the risk and/or return of an investment based on appropriate investment horizons consistent with the plan's investment objectives and funding policy. The term “investment course of action” is defined in paragraph (f)(2) of the final rule to mean “any series or program of investments or actions related to a fiduciary's performance of the fiduciary's investment duties, and includes the selection of an investment fund as a plan investment, or in the case of an individual account plan, a designated investment alternative under the plan.” Second, the final rule includes an express regulatory provision stating that

compliance with the exclusive purpose (loyalty) duty in ERISA section 404(a)(1)(A) prohibits fiduciaries from subordinating the interests of participants to unrelated objectives, and bars them from sacrificing investment return or taking on additional investment risk to promote non-pecuniary goals. Third, the final rule includes a provision that requires fiduciaries to consider reasonably available alternatives to meet their prudence and loyalty duties under ERISA. Fourth, new regulatory text sets forth required investment analysis and documentation requirements for those circumstances in which plan fiduciaries use non-pecuniary factors when choosing between or among investments that the fiduciary is unable to distinguish on the basis of pecuniary factors alone. The final rule includes a related documentation requirement for such decisions intended to prevent fiduciaries from improperly finding economic equivalence or making investment decisions based on non-pecuniary benefits without appropriately careful analysis and evaluation. Fifth, the final rule states that the prudence and loyalty standards set forth in ERISA apply to a fiduciary's selection of designated investment alternatives to be offered to plan participants and beneficiaries in a participant-directed individual account plan. The final rule expressly provides that, in the case of selecting investment alternatives for an individual account plan that allows plan participants and beneficiaries to choose from a broad range of investment alternatives, as defined in 29 CFR 2550.404c-1(b)(3), a fiduciary is not prohibited from considering or including an investment fund, product, or model portfolio merely because the fund, product, or model portfolio promotes, seeks, or supports one or more non-pecuniary goals, provided that the fiduciary satisfies the prudence and loyalty provisions in ERISA and the final rule, including the requirement to evaluate solely on pecuniary factors, in selecting any such investment fund, product, or model portfolio. However, the provision prohibits plans from adding any investment fund, product, or model portfolio as a qualified default investment alternative described in 29 CFR 2550.404c-5, or as a component of such an investment alternative, if the fund, product, or model portfolio's investment objectives or goals or its principal investment strategies include, consider, or indicate the use of one or more non-pecuniary factors.

The provisions of the final rule are discussed below along with relevant public comments.

#### 1. Section 2550.404a-1(a) and (b)—General Prudence and Loyalty Investment Duties

The final rule builds upon the core principles provided by the original investment duties regulation on the issue of prudence under section 404(a)(1)(B) of ERISA, at 29 CFR 2550.404a-1, which the regulated community has been relying upon for more than 40 years.<sup>27</sup> For example, as stated in the preamble to the 1979 regulation, it remains the Department's view that (1) generally the relative riskiness of a specific investment or investment course of action does not render such investment or investment course of action either per se prudent or per se imprudent, and (2) the prudence of an investment decision should not be judged without regard to the role that the proposed investment or investment course of action plays within the overall plan portfolio. It also remains the Department's view that an investment reasonably designed—as part of the portfolio—to further the purposes of the plan, and that is made with appropriate consideration of the relevant facts and circumstances, should not be deemed to be imprudent merely because the investment, standing alone, would have a relatively high degree of risk. The Department also continues to believe that appropriate consideration of an investment to further the purposes of the plan must include consideration of the characteristics of the investment itself and how it relates to the plan portfolio.

Paragraph (a) of the final rule is unchanged from the proposal and includes a restatement of the statutory language of the exclusive purpose requirements of ERISA section 404(a)(1)(A) and the prudence duty of ERISA section 404(a)(1)(B). The existing 404a-1 regulation already included a restatement of the prudence duties that apply to fiduciary investment decisions under ERISA section 404(a)(1)(B). The final rule thus reinforces the core principles provided in the investment duties regulation by expressly referencing the separate loyalty duty imposed on fiduciary investment decisions under ERISA section 404(a)(1)(A). In effect, paragraph (a) of this final rule amends paragraph (a) in the 1979 investment duties regulation by adding the exclusive purpose requirements to the existing duty of prudence. That application of these

<sup>27</sup> 44 FR 37221, 37225 (June 26, 1979).

prudence and loyalty requirements is context-specific and depends on the facts and circumstances as made clear by the rest of the provisions of the rule.

Some commenters asserted that the combination of prudence and loyalty in paragraph (a) of the proposal, together with the requirements of paragraph (b) as to how to satisfy those joint requirements when evaluating investments, were not simple clarifications of the existing investment duties regulation. Rather, in their view, that combination of amendments would have constituted the development of a new theory of loyalty beyond the Department's stated objective to address ESG investment developments, and which would have resulted in confusion regarding investment duties more generally. Some commenters, moreover, argued that the proposal's combination of amendments could violate established principles of statutory construction by establishing a regulation under which compliance with a single set of objective requirements would be sufficient to satisfy the requirements of both section 404(a)(1)(A)'s duty of loyalty and (B)'s duty of prudence. Unlike ERISA's duty of prudence, the duty of loyalty has not been interpreted by the courts to be an objective test requiring compliance with appropriate procedures, but has instead been measured by the subjective intent or motivation of the fiduciaries, according to the commenters. Nor have the courts extended the duty of loyalty to prohibit a fiduciary from considering implications external to the fiduciary's self-interest, so long as the fiduciary was focused on benefiting participants and beneficiaries and defraying reasonable plan expenses, according to the commenters. And finally, some commenters asserted that at least some authority interprets ERISA section 404(a)(1)(A) to permit some incidental benefits to others' interests as long as the primary purpose and effect of the action is to benefit the plan.

As to the interplay between paragraphs (a), (b), and (c) of the proposal, one commenter requested clarification that paragraph (b) of the proposal was intended to continue as a safe harbor, and was not the exclusive means for satisfying prudence. This commenter observed that the Department originally described paragraph (b) as a safe harbor in 1979 when the investment duties regulation was originally published. This commenter was concerned that the specific requirements of paragraph (c) of the proposal did not appear to constitute a safe harbor. This commenter argued that if the

Department's intent is to transform paragraph (b) from a safe harbor into minimum requirements, the Department must provide specific notice of this fact and solicit comments from the public while also assessing the costs and benefits of such a change.

Some commenters also raised concerns that the Department should not have multiple prongs in the regulation variously stating that a fiduciary "should not subordinate" and "should not otherwise subordinate." Similarly, one commenter argued that the phrase in the proposal "and has otherwise complied with the duty of loyalty" is circular because it includes compliance with the duty of loyalty as an element of complying with the duty of loyalty. Commenters argued that the addition of the phrase "the duty of loyalty" inside the definition of the duty of loyalty creates an invitation for courts to graft on additional responsibilities not included within either the Department's rule or section 404(a)(1)(A) of ERISA.

One commenter asked the Department to replace its multi-part articulation of the duty of loyalty in the proposal with a simple clarification stating that "a fiduciary may not subordinate the interests of participants and beneficiaries as retirement savers to any other interests of the participants, beneficiaries, the fiduciary itself or any other party." This commenter also proposed eliminating paragraph (c) regarding pecuniary factors in investment decisions altogether. The commenter argued that the advantage would be an easily understood, one-part test that captures both elements of the proposal without the need for special rules for "pecuniary factors" and other rules for "non-pecuniary factors."

Other commenters argued that the prohibition in paragraph (b) against subordinating the interest of the participants and beneficiaries to the fiduciary's or another's interest is unnecessary in light of ERISA's prohibited transaction provisions, and, moreover, would likely have unintended consequences by making many common, accepted, and generally beneficial practices suspect, such as the use of proprietary products, fee sharing, and fee aggregation.

The principles of loyalty under section 404(a)(1)(A) of ERISA prohibit a fiduciary from subordinating the interests of the participants and beneficiaries in their retirement income or other financial benefits under the plan to unrelated objectives. No commenter suggested to the contrary. Thus, the Department believes that including the duty of loyalty in a

regulatory provision regarding investment activity should not be the surprise nor innovation some commenters alleged.

The Department is persuaded by the comments that there is a better way than presented in the proposal to express the view that a fiduciary engaged in investments and investment courses of action may not subordinate the interests of the plan to unrelated objectives and that the fiduciary needs to focus on the pecuniary interests of the plan in complying with its prudence obligation under the plan. The Department is persuaded by the comments that it would be preferable to retain paragraph (b) as a provision addressing only the ERISA section 404(a)(1)(B) prudence duty and revising paragraphs (c) and (d) to more specifically address the element of the duty of loyalty that requires fiduciaries to focus investment decision-making on providing financial benefits to participants under the plan and prohibits fiduciaries from subordinating the interests of participants and beneficiaries in their retirement income or financial benefits under the plan to unrelated objectives. This approach incorporates the duty of loyalty into the regulation while recognizing that the statute sets forth the duty of prudence and the duty of loyalty as separate fiduciary obligations.

Further, the Department is persuaded by the comments that the "safe harbor" nature of paragraph (b) in the original investment duties regulation should be preserved. However, the Department does not agree that its safe-harbor characterization of the 404a-1 regulation in 1979 can fairly be read to suggest an unrestricted open field. Rather, in describing the regulation as a safe harbor, the Department cautioned that it was expressing no view on whether the prudence duty could be satisfied outside of the "safe harbor" provisions in the regulation: "It should also be noted that the Department does not view compliance with the provisions of the regulation as necessarily constituting the exclusive method for satisfying the requirements of the 'prudence' rule. Rather, the regulation is in the nature of a 'safe harbor' provision; it is the opinion of the Department that fiduciaries who comply with the provisions of the regulation will have satisfied the requirements of the 'prudence' rule, but *no opinion is expressed in the regulation as to the status of activities undertaken or performed that do not so comply.*"<sup>28</sup> Although there may be

<sup>28</sup> 44 FR at 37222 (June 26, 1979) (emphasis added).



distinct circumstances where some other process would be prudent, in every case, ERISA fiduciaries are required to have a soundly reasoned and supported investment decision or strategy to satisfy the ERISA prudence requirement.

As a result, proposed paragraph (b)(1) is modified in the final rule to remove the general references to the duty of loyalty under section 404(a)(1)(A) of ERISA, such as those contained in paragraphs (b)(1)(iii) and (iv) of the proposal, and to maintain its character as a safe harbor for prudent investment and investment courses of action as described in the original 1979 investment duties regulation. However, the safe harbor in paragraph (b) applies only to the duty of prudence under section 404(a)(1)(B) of ERISA. Under the final rule, the provisions set forth in paragraphs (c) and (d) are set forth as minimum requirements with respect to the aspects of the duty of loyalty addressed in those paragraphs, including the obligation to focus on pecuniary factors when making investment decisions. Thus, the final rule does not revise the current requirements that the fiduciary give appropriate consideration to a number of factors concerning the composition of the plan portfolio with respect to diversification, the liquidity and current return of the portfolio relative to the anticipated cash flow needs of the plan, and the projected return of the portfolio relative to the funding objectives of the plan. Paragraph (b)(1) of the final rule continues to provide that with regard to the consideration of an investment or investment course of action taken by a fiduciary of an employee benefit plan pursuant to the fiduciary's investment duties, the requirements of section 404(a)(1)(B) of the Act set forth in paragraph (a) are satisfied if the fiduciary (i) has given appropriate consideration to those facts and circumstances that, given the scope of such fiduciary's investment duties, the fiduciary knows or should know are relevant to the particular investment or investment course of action involved, including the role the investment or investment course of action plays in that portion of the plan's investment portfolio with respect to which the fiduciary has investment duties, and (ii) has acted accordingly.

Paragraph (b)(2) of the proposal provided that for purposes of paragraph (b)(1) of the proposal, "appropriate consideration" shall include, but is not necessarily limited to (i) a determination by the fiduciary that the particular investment or investment course of action is reasonably designed,

as part of the portfolio (or, where applicable, that portion of the plan portfolio with respect to which the fiduciary has investment duties), to further the purposes of the plan, taking into consideration the risk of loss and the opportunity for gain (or other return) associated with the investment or investment course of action, and (ii) consideration of the composition of the portfolio with regard to diversification, the liquidity and current return of the portfolio relative to the anticipated cash flow requirements of the plan, the projected return of the portfolio relative to the funding objectives of the plan as those factors relate to such portion of the portfolio, and how the investment or investment course of action compares to available alternative investments or investment courses of action with regard to those factors listed.

Paragraph (b)(2) of the proposal was essentially the same as the provision in the 1979 investment duties regulation except for proposed paragraph (b)(2)(ii)(D) which required the consideration of how the investment or investment course of action compares to available alternative investments or investment courses of action with regard to those factors listed in paragraphs (b)(2)(ii)(A) through (C). Thus, most related comments concerned proposed paragraph (b)(2)(ii)(D). Commenters assert that this provision is unclear as to extent of the requirement to evaluate alternatives. In some cases, commenters alleged, there may be no true alternative to a particular investment, because the opportunity is so unique. In other cases, the opportunity may lapse if a thorough undertaking of all alternatives is pursued. In yet other situations, the number of potential alternatives might be so numerous that consideration of every alternative is impossible. This lack of clarity may give rise to inappropriate second-guessing in which questions are raised as to whether a particular alternative (selected with the benefit of hindsight) should have been considered. Similarly, some commenters complained that the requirement does not necessarily take into account the complexities involved in defined benefit plan investment, which varies, among other items, by plan design, participant census, the sponsor's risk tolerance and a company's cash, and whether a proposed investment adds litigation risk. Commenters also argued the proposed provision may be at odds with the ERISA section 404(c) regulation because it is unclear what "available alternative investments" means in the context of satisfying the 404(c)

regulation's requirement to make available at least three investment alternatives meant to provide a broad-based selection. Further, commenters asked how to apply the obligation to consider alternative investments applies in situations where company stock is purchased for a plan through a plan provision that mandates such purchase.

Commenters were concerned that the proposed rule provides no guidance as to how the relevant alternatives would be determined and how many of those alternatives the fiduciary is to use in performing the newly required comparison. For example, one commenter posited that the proposal might be read to require a fiduciary making a decision on a diversified stock fund that falls within Morningstar's large cap growth category to compare that investment to all of the approximately 1,350 mutual funds within that category. Some commenters suggested that the Department should tell fiduciaries exactly how to conduct such an analysis to make the best prospective decision. Some expressed concern that the requirement opened fiduciaries to "20/20 hindsight" legal attacks by class action lawyers.

The Department notes that the concept of comparing available investment alternatives is not new. Interpretive Bulletins on ESG and ETI investing issued by the Department expressed the view that facts and circumstances relevant to an investment or investment course of action would, in the view of the Department, include consideration of the expected return on alternative investments with similar risks available to the plan. Specifically, the Department observed that, because every investment necessarily causes a plan to forego other investment opportunities, an investment would not be prudent if it were expected to provide a plan with a lower rate of return than available investment alternatives with commensurate degrees of risk, or were riskier than available investment alternatives with commensurate rates of return.<sup>29</sup> Such an analysis is similar to that required by paragraph (b)(2)(ii)(D) of the proposal. As a result, the concept of comparing investment opportunities as set forth in paragraph (b)(2)(ii)(D) cannot fairly be cast as new to the retirement investing community.

Furthermore, the proposal was not intended to require fiduciaries to "scour the market" and incur search costs on a practically infinite number of potential portfolios, nor could such a requirement be consistent with the duty

<sup>29</sup> See 29 CFR 2509.94-1 and 2509.2015-01.



of prudence.<sup>30</sup> Rather, as the Department noted when it issued the 404a–1 regulation in 1979, the Department recognizes that a fiduciary should be required neither to expend unreasonable efforts in discharging his duties, nor to consider matters outside the scope of those duties. Accordingly, the regulation requires fiduciaries to give consideration to those facts and circumstances which, taking into account the scope of his investment duties, the fiduciary knows or should know are relevant to the particular investment decision involved.<sup>31</sup> The scope of the fiduciary’s inquiry in this respect, therefore, is limited to those facts and circumstances that a prudent person having similar duties and familiar with such matters would consider relevant. That same principle applies to consideration of alternative investment opportunities.

Accordingly, the Department has determined to keep the general concept of paragraph (b)(2)(ii)(D) in the final rule. However, we believe a better approach than the proposal is one that incorporates the concept in a way that is consistent with the Department’s prior IB statements and at the same time addresses the requests of commenters for guidance as to the extent of the requirement to evaluate alternatives. The Department added new language to paragraph (b)(2)(i) to state that the consideration of risk and loss and the opportunity for gain (or other return) associated with the investment or investment courses of action should take place “compared to the opportunity for gain (or other return) associated with reasonably available alternatives with similar risks.” Under the final rule, a fiduciary is required only to compare alternatives that are reasonably available under the circumstances. The Department used the phrase “reasonably available alternatives” not only to confirm that the rule does not require fiduciaries to scour the market or to consider every possible alternative, but also to allow for the possibility that the characteristics and purposes served by a given investment or investment course of action may be sufficiently rare that a fiduciary could prudently determine, and document, that there were no other reasonably available alternatives for purpose of this comparison requirement. As a result, paragraph (b)(2) of the final rule provides that for purposes of paragraph (b)(1), “appropriate consideration” shall

include, but is not necessarily limited to (i) a determination by the fiduciary that the particular investment or investment course of action is reasonably designed, as part of the portfolio (or, where applicable, that portion of the plan portfolio with respect to which the fiduciary has investment duties), to further the purposes of the plan, taking into consideration the risk of loss and the opportunity for gain (or other return) associated with the investment or investment course of action compared to the opportunity for gain (or other return) associated with reasonably available alternatives with similar risks, and (ii) consideration of the composition of the portfolio with regard to diversification, the liquidity and current return of the portfolio relative to the anticipated cash flow requirements of the plan, the projected return of the portfolio relative to the funding objectives of the plan as those factors relate to such portion of the portfolio, and how the investment or investment course of action compares to alternative investments or investment courses of action that were considered with regard to those factors listed.

With respect to the comments arguing that ERISA section 404(a)(1)(A) is purely a subjective motivation test, the Department does not believe that is a viable analytical approach and is concerned that such an interpretation would raise substantial feasibility questions about the application and enforcement of such a requirement. Rather, while motivation is undeniably a proper focus in applying a loyalty requirement under which fiduciary action must be based solely on the interests of participants and beneficiaries and for their “exclusive benefit,” the Department believes that establishing regulatory guideposts, like the requirement to focus on pecuniary factors in investment decision-making, is an appropriate way to establish objective criteria that help fiduciaries understand how to comply with their duty of loyalty in the context of evaluating financial factors when selecting investments or investment courses of action.

Since the scope of paragraph (b) in the final rule has been revised from the proposal to encompass only the obligations set forth in ERISA section 404(a)(1)(B), the proposal’s inclusion in paragraph (b)(1)(iv) of a specific prohibition on a fiduciary subordinating the interests of participants and beneficiaries to the fiduciary’s or another’s interest is unnecessary. The Department further agrees that it is not necessary to have multiple provisions of the final rule contain the prohibition on “not subordinating” the interests of

participants and beneficiaries. Thus, the Department eliminated paragraph (b)(1)(iv) of the proposal from the final rule, and, as described below, revised the final rule to address the Department’s concerns regarding a focus in fiduciary investment activity on “pecuniary factors” through a revised provision in paragraph (c).<sup>32</sup>

Paragraph (b)(3) of the final rule merely moves what was paragraph (d) of the proposal to this new position in the regulatory text. This move was judged appropriate because the paragraph concerns compliance with the immediately preceding regulatory text of paragraphs (b)(1) and (2). Paragraph (d) of the proposal repeated a paragraph in the current 404a–1 regulation which states that an investment manager appointed pursuant to the provisions of section 402(c)(3) of the Act to manage all or part of the assets of a plan may, for purposes of compliance with the provisions of paragraphs (b)(1) and (2) of the proposal, rely on, and act upon the basis of, information pertaining to the plan provided by or at the direction of the appointing fiduciary, if such information is provided for the stated purpose of assisting the manager in the performance of the manager’s investment duties, and the manager does not know and has no reason to know that the information is incorrect. This provision was originally part of the 1979 regulation, has remained unchanged since then, and no commenter suggested that the substance of the provision be changed. Paragraph (b)(3) of the final rule is essentially the same as the parallel provision in the original 1979 investment duties regulation.

## 2. Section 2550.404a–1(c)(1)— Consideration of Pecuniary Factors

Paragraph (c)(1) of the proposed rule required that a fiduciary’s evaluation of an investment be focused only on pecuniary factors. The proposal expressly provided that it is unlawful for a fiduciary to sacrifice return or

<sup>32</sup> For similar reasons, the final rule does not carry forward the reference to the parallel exclusive purpose provision in ERISA section 403 that was in the proposal. The Department also concluded that the final rule should continue the focus of the current 404a–1 regulation on section 404 of ERISA. Section 403(c) of ERISA provides in relevant part that the assets of the plan shall never inure to the benefit of any employer and shall be held for the exclusive purpose for providing benefits to participants in the plan and their beneficiaries and defraying reasonable expenses of the plan. Although similar, the text of ERISA section 403 is not identical to section 404(a)(1)(A) of ERISA, and the Department wanted to avoid any possible inference that compliance with the provisions of the final rule would also necessarily satisfy all the provisions of section 403 of ERISA.

<sup>30</sup> See *Hecker v. Deere & Co.*, 556 F.3d 575, 586 (7th Cir. 2009) (“nothing in ERISA requires every fiduciary to scour the market”).

<sup>31</sup> See 44 FR at 37223 (June 26, 1979).

accept additional risk to promote a public policy, political, or any other non-pecuniary goal. Paragraph (c)(1) also expressly acknowledged that ESG factors and other similar considerations may be pecuniary factors and economic considerations, but only if they present economic risks or opportunities that qualified investment professionals would treat as material economic considerations under generally accepted investment theories. The proposal emphasized that such factors, if determined to be pecuniary, must be considered alongside other relevant economic factors to evaluate the risk and return profiles of alternative investments. The proposal further provided that the weight given to pecuniary ESG factors should reflect a prudent assessment of their impact on risk and return—that is, they cannot be disproportionately weighted. The proposal also emphasized that fiduciaries' consideration of ESG factors must be focused on their potential pecuniary elements by requiring fiduciaries to examine the level of diversification, degree of liquidity, and the potential risk-return profile of the investment in comparison with available alternative investments that would play a similar role in their plans' portfolios.

A number of commenters offered nearly unqualified support for the rule, and endorsed the Department's efforts in moving forward with the proposal. Although some commenters expressed concern that the rule was complex and posed possible attendant compliance costs and uncertain legal liabilities, they deemed these costs justified by the protections offered by the proposal. Commenters also shared the concern of the Department that the growing emphasis on ESG investing may be prompting ERISA plan fiduciaries to make investment decisions for purposes distinct from providing benefits to participants and beneficiaries and defraying reasonable expenses of administering the plan. They agreed that the proposal was designed to make clear that ERISA plan fiduciaries may not invest in ESG vehicles when they understand an underlying investment strategy of the vehicle is to subordinate return or increase risk for the purpose of non-pecuniary objectives. They stated that investments should be made based on an evaluation of whether the investments will improve the financial performance of the plan. Other commenters stated that while they support individual investors' ability to pursue ESG investments that align with their values, they support the proposal's

focus on decisions made by ERISA fiduciaries on plan participants' behalf, where enhancing financial returns is the overriding legal obligation of ERISA plan fiduciaries when making investment decisions. Some commenters supported the proposal's acknowledgement that ESG factors and other similar considerations may be economic considerations and the proposal's guidance to fiduciaries regarding how to consider pecuniary ESG factors when contemplating an investment decision, such as the importance of understanding the "economic risks or opportunities" attached to such considerations and appropriately weighing pecuniary ESG factors based on "a prudent assessment of their impact on risk and return" alongside other relevant economic factors necessary to make an investment decision. These commenters said that the proposed regulation would protect plan participants by ensuring that ERISA fiduciaries are making reasoned investment decisions based on all material information, including pecuniary ESG factors, available to them. Other commenters shared DOL's concern that the growing emphasis on ESG investing may be prompting fiduciaries to make investment decisions for reasons other than maximizing return to beneficiaries. Some commenters asserted that some ESG-focused funds have a stated goal of subordinating investor return or increasing investor risk for the purpose of achieving political or social objectives, citing ESG funds' disclosures that the commenters said highlighted the potential for reduced returns, increased risks, and heightened fees in service of social goals. These commenters asserted that the proposed rule clarifies that ERISA plan fiduciaries may not invest in ESG funds when the investment strategy of the fund subordinates return or takes on additional investment risk or costs for purposes of non-pecuniary objectives.

Many commenters, however, expressed concern that the Department did not classify ESG as material financial factors that should be considered by fiduciaries in their investment evaluation and decision-making. They pointed to evidence and research that they asserted makes clear that ESG factors *are* material economic considerations that *must* be integrated into fiduciary investment decisions. Some commenters asserted that ESG integration has been evolving and growing for decades primarily to help manage investment risks and to provide a proxy for management quality, which,

they argued, were both pecuniary factors. Other commenters stated that the proposed rule appeared to be based on a presumption that ESG funds commonly select portfolio constituents based on "non-pecuniary" factors, without regard to risk and return. These commenters stated that they were not aware of any fund managers that select portfolio constituents without regard to financial performance, or risk and return.

Some commenters acknowledged that the proposal expressly provided that ESG factors and other similar considerations may be pecuniary factors and economic considerations, but argued that, if the purpose of the rule is to establish a clear distinction between ESG used for risk-return assessment and ESG used for collateral benefits (*e.g.* ESG investing for moral or ethical reasons or to benefit a third party), the Department should better define ESG risk-return factors to more clearly distinguish between the permissible and impermissible uses thereof, which are the heart of this issue. Some commenters similarly argued that the proposal would cause confusion because of its failure to distinguish ESG integration and economically targeted investing. ESG integration, the commenters assert, is the consideration of ESG factors as part of prudent risk management and a strategy to take investment actions aimed at responding to those risks, whereas economically targeted investing, by comparison, is investing with the aim to provide financial as well as collateral, non-financial benefits. These commenters argued that the proposal is aimed at ETIs and problems associated with ETIs rather than ESG integration into the risk-return analysis of investments, and raised concerns that the lack of a clearer distinction between the two in the proposal will discourage proper ESG risk-return integration. Another commenter raised a similar concern, but in the specific context of selecting investment funds for individual account plans, by asking that the Department distinguish between ESG-themed investment funds, where the primary investment strategy or principal purpose is to promote impermissible collateral benefits, and those investment funds that are not primarily focused on ESG factors, but instead use one or more ESG factors as part of their overall investment analysis.

Some commenters asserted that instead of providing the needed flexibility to consider all material factors, the proposal would unnecessarily limit the discretion of the fiduciary to determine that ESG factors

may have a “material effect on the return and risk of an investment” by requiring “qualified investment professionals” to treat the factor as material economic considerations under generally accepted investment theories. They argued that the proposal, although based on generally accepted investment theories which by definition include changes to reflect an evolving financial marketplace, would still place restraints on the discretion fiduciaries need to adjust their investment practices to keep pace with the constantly changing investment landscape and emerging theories that develop alongside. For example, some commenters stated that the Department should avoid a regulatory structure that would require the Department and plan fiduciaries to referee references to “qualified investment professionals,” “material,” and “generally accepted investment theories.” The commenters expressed concern that those terms invite subjective interpretations. One commenter expressed concern that some parties will likely attempt to undermine the rule’s intent with claims that ESG-focused investing is already “generally accepted.” Other commenters argued that the proposal creates a heightened level of scrutiny for investments that involve ESG-integration that do not apply to any other type of investment.

Many commenters stated that EBSA ignored academic and financial studies and papers showing that more sustainable companies and funds do not sacrifice performance compared with less sustainable peers, and in fact are somewhat more likely to outperform than to underperform. They cite, for example, a 2018 Government Accountability Office study that concluded the majority of asset managers interviewed found that incorporating ESG factors enhanced retirement plans’ risk management.<sup>33</sup> The GAO also noted more than half of the asset managers interviewed were “incorporating ESG factors to improve the long-term performance of retirement plan portfolios.” Another commenter cited a study saying that sustainable funds provided returns in line with comparable traditional funds while reducing downside risk. During a period of extreme volatility, the commenters assert that they saw strong statistical evidence that sustainable funds are more stable. A 2015 Harvard Business School paper found that firms with

strong ratings on material sustainability issues have better future performance than firms with inferior ratings on the same issues. In contrast, firms with strong ratings on immaterial issues do not outperform. Some commenters stated that numerous sophisticated investors have indicated that their ESG investments, social benefits notwithstanding, are fundamentally driven by expected financial returns, including considerations regarding long-term value, opportunity, and risk, and cited studies indicating that an ESG perspective can improve performance, including studies that purport to show, according to the commenters, that ESG-focused indexes have matched or exceeded returns of their standard counterparts, with comparable volatility. They also cited studies purporting to show that investors who screened for ESG factors could have avoided 90 percent of S&P 500 bankruptcies from 2005 to 2015 and that S&P 500 companies in the top 25 percent by ESG ratings experienced lower future earnings-per-share volatility than those in the bottom 25 percent. A commenter observed, in its view, that there was better risk-adjusted performance across “sustainable” products globally under recent market stress (including severe turmoil in the first quarter of 2020).

Representatives of the multiemployer plan community commented on the proposal’s provisions requiring that the focus of fiduciaries when making investment decisions must be on pecuniary interests of the plan, and requested that the Department add a particular consideration within the meaning of “pecuniary” factor. According to these commenters, the proposal failed to consider and distinguish between the different types of defined benefit pension plans and how relevant pecuniary factors might differ between different types of ERISA plans. They asserted that there are several differences between multiemployer and single employer defined benefit pension plans relevant for purposes of this regulation: The source and nature of plan contributions; the pecuniary impact of contributions on the plan, its participants, and beneficiaries; and the consequent ability of the plan to make investments that advance, promote, and support the pecuniary interests of the plan, its participants, and beneficiaries through plan contributions. These commenters argued that, unlike single employer plans, multiemployer plans have a significant track record of being able to make investments that earn competitive

risk-adjusted returns and that directly put plan participants to work, thereby generating new contributions to the plan. According to these commenters, if a given investment results in a pension fund receiving additional contributions, such contributions are as much a pecuniary factor as any gain or loss on the investment. Some commenters made a similar point with respect to defined contribution plans. They asserted that increased participation and contributions should be recognized as pecuniary factors for defined contribution plans and pointed to surveys demonstrating that including ESG investment alternatives has a positive effect on employees’ interest in participating in and contributing to retirement savings plans.

Some commenters questioned the proposal’s requirement to consider only pecuniary factors when ERISA investment fiduciaries routinely consider non-pecuniary interests as part of their fiduciary process. They argued, for example, that ERISA specifically provides for plan investments in qualifying employer securities. In the case of employee stock ownership plans (ESOPs), they noted that such plans are designed for investment primarily in employer securities. They said that the proposal conflicted with statutory authorization to invest in employer securities by requiring plan fiduciaries to justify the inclusion of company stock based solely on “pecuniary” factors and by comparison to “available alternative investments or investment courses of action.” Other commenters suggested that the proposal’s focus on risk-return features of an investment or investment course of action would likely have unintended consequences on many common, accepted, and generally beneficial practices by rendering them suspect, such as the use of proprietary products, fee sharing, and fee aggregation. Some comments contended that investment managers and fiduciaries routinely take into consideration a variety of factors that do not necessarily have a “material effect on the risk and/or return” of a particular investment. They cited, for example, that a plan committee may consider a fund manager’s brand or reputation when determining whether to include that fund in the plan’s menu. A fiduciary might account for operational considerations when selecting one investment fund over another, where those operational considerations may have a bearing on the fees borne by participants or the smooth operation of the plan. A fiduciary also might decide to choose an investment regulated in

<sup>33</sup> Government Accountability Office Report No. 18–398, *Retirement Plan Investing: Clearer Information on Consideration of Environmental, Social, and Governance Factors Would Be Helpful* (2018).

one legal regime over another because of the protection the fiduciary believes the particular regulatory regime offers, or it might find the disclosures produced by one investment provider easier for participants to understand. Another commenter noted that reasonable and necessary plan administrative expenses are commonly offset with payments or credits attributable to the plan's investment options, and asked whether the focus on risk-return characteristics would prohibit a fiduciary from considering the administrative fee offset the plan would receive when selecting an investment option. Some commenters expressed concern that the proposal also could encourage litigation by having the plaintiffs' bar second-guess whether a decision is solely for the financial benefit of participants and beneficiaries based on incidental benefits that may accrue to plan fiduciaries (even though case law and Departmental guidance have approved such benefits if they are merely incidental and flow from a fiduciary decision that satisfies ERISA's prudence and loyalty requirements).<sup>34</sup> One of these commenters also expressed concern about such litigation alleging that the selection of one investment over another sacrificed investment returns even if the decision was justified by the use of revenue sharing to obtain lower administrative fees.

Some commenters argued that the Department's focus on risk and return was not an appropriate approach for addressing ESG considerations in decisions regarding management of plan investments. They argued that given the critical importance of overall market return, and the danger to that return from company activities that damage social and environmental systems, plan beneficiaries need protection from individual companies that focus on their own performance in ways that damage overall market return. Commenters argued that in order to protect the interest of plans and beneficiaries, plan fiduciaries must consider whether they can effectively engage with companies to limit or eliminate conduct that threatens the social and economic systems that diversified portfolios rely on over the long term. They argued that fiduciary

investors must focus on and prioritize outcomes at the economy or society-wide scale, or "beta" issues such as climate change and corruption, not just on the risks and returns of individual holdings. They contended that fiduciary investment duties must prioritize the long-term, absolute returns for "universal owners," and that collective investor action to manage social and environmental systems is needed in order to satisfy the fiduciary duties of investment trustees.

One commenter suggested that the definition of "pecuniary factor" was too narrow and recommended modifying it to mean a factor *that could reasonably be expected* to have a material effect on the risk and/or return of an investment based on appropriate investment horizons consistent with the plan's investment objectives and the funding policy established pursuant to section 402(b)(1) of ERISA.

Still another commenter suggested that "appropriate investment horizon" be better defined in the definition of "pecuniary factor" to ensure that the long-term horizons for certain policy objectives are not substituted for those relating to the time-horizon of retirees.

As the Department explained in the proposal, it is the long-established view of the Department that ERISA fiduciaries must always put first the economic interests of the plan in providing retirement benefits. A fiduciary's evaluation of the economics of an investment should be focused on financial factors that have a material effect on the return and risk of an investment based on appropriate investment horizons consistent with the plan's articulated funding and investment objectives. In the preamble to the proposal, the Department recognized that there could be instances when ESG issues present material business risk or opportunities to companies that company officers and directors need to manage as part of the company's business plan and that qualified investment professionals would treat as economic considerations under generally accepted investment theories. In such situations, these issues are themselves appropriate economic considerations, and thus should be considered by a prudent fiduciary along with other relevant economic factors to evaluate the risk and return profiles of alternative investments. The proposal even provided additional guidance as to when it was appropriate to consider ESG matters as pecuniary factors in making investment decisions. Thus, the proposal fundamentally accepted, rather than ignored as claimed by some commenters, the economic literature

and fiduciary investment experience that showed ESG considerations may present issues of material business risk or opportunities to companies that company officers and directors need to manage as part of the company's business plan and that qualified investment professionals would treat as economic considerations under generally accepted investment theories. Rather, the proposal sought to make clear that, from a fiduciary perspective, the relevant question is not whether a factor under consideration is "ESG", but whether it is a pecuniary factor relevant to an evaluation of the investment or investment course of action under consideration. Nonetheless, the Department is persuaded by its review of the public comments that "ESG" terminology, although used in common parlance when discussing investments and investment strategies, is not a clear or helpful lexicon for a regulatory standard. As one commenter put it, "ESG investing" resists precise definition." Rather, "[r]oughly speaking, it is an umbrella term that refers to an investment strategy that emphasizes a firm's governance structure or the environmental or social impacts of the firm's products or practices." The Department agrees that ESG terminology suffers from two distinct shortcomings as a regulatory standard. First, as the Department noted in the proposal, and many commenters agreed, various other terms have been used to describe this and related investment behaviors, such as socially responsible investing, sustainable and responsible investing, impact investing, and economically targeted investing. Moreover, the terms do not have a uniform meaning and the terminology is evolving, and the non-pecuniary goals being advocated today may not be the same as those advocated in future years. Second, by conflating unrelated environmental, social, and corporate governance factors into a single term, ESG invites a less than appropriately rigorous analytical approach in evaluating whether any given E, S, or G consideration presents a material business risk or opportunity to a company that corporate officers and directors should manage as part of the company's business plan and that qualified investment professionals would treat as economic considerations in evaluating an investment in that company. The Department also believes that adopting ESG terminology in an investment duties regulation invites the arguments, made by some commenters, that all manner of ESG considerations are always and in every case a pecuniary factor that must be

<sup>34</sup> See *Lockheed Corp. v. Spink*, 517 U.S. 882 (1996); *Hughes Aircraft Co. v. Jacobsen*, 525 U.S. 432 (1999). See also Advisory Opinion 2011-05A (noting that a fiduciary decision to use plan assets to add a wellness benefit to plan benefits under existing, supplemental or new insurance policies or contracts would not violate ERISA because the employer sponsoring the plan may receive incidental benefits, such as lower plan costs, as a result of the wellness benefits being added to the plan).

considered as such in all investment decisions, or even that ESG should be a mandatory investment strategy for prudent fiduciaries. Such positions are inconsistent with the Department's considered view and sound policy.

Thus, the final rule removes all ESG terminology from the proposed regulatory text. The Department anticipates that when a fiduciary is faced with a purported ESG factor in an investment, the regulatory requirement will be clearer and more consistent if it demands that fiduciaries focus on providing participants with the financial benefits promised under the plan and focus on whether a factor is pecuniary, rather than being required to navigate imprecise and ambiguous ESG terminology. The ERISA fiduciary duty of prudence requires portfolio-level attention to risk and return objectives reasonably suited to the purpose of the account, diversification, cost-sensitivity, documentation, and ongoing monitoring. The proposal was not intended to suggest that these principles apply other than neutrally to all investment decisions by a trustee or other fiduciary, whether in the context of a direct investment or menu construction in an individual account plan. For similar reasons, the Department declines to follow suggestions from some commenters that ESG factors are necessarily pecuniary and that the Department should specifically mandate that fiduciaries consider ESG factors as part of their investment duties.

At the time of the investment decision, fiduciaries should be focused on whether or not any given factor would materially affect the risk and/or return of the investment over an appropriate time horizon. The intent of the proposal was to address the Department's continued concern about the growing emphasis on ESG investing that seeks to achieve non-pecuniary objectives or goals that are unrelated to the interests of the plan's participants and beneficiaries in their retirement income or financial benefits under the plan, and the consequence that ERISA plan fiduciaries may be prompted to make investment decisions for purposes distinct from providing benefits to participants and beneficiaries and defraying reasonable expenses of administering the plan. Thus, the proposal was intended to ensure that ERISA fiduciaries comply with their investment duties in a consistent and appropriate fashion in the face of ESG-driven market developments.<sup>35</sup> The

Department believes that the generally applicable prudence requirements in paragraph (a) of the final rule, together with a requirement in paragraphs (c) and (d) of the final rule demanding a focus on pecuniary factors and the definition of pecuniary factors in paragraph (f), are sufficient to establish an appropriate regulatory standard in this context.

As a result, paragraph (c)(1) of the final rule retains the requirement in the proposal that fiduciary evaluation of an investment must be focused only on pecuniary factors. As in the proposal, the final rule's paragraph (c)(1) is a legal requirement and not a safe harbor. The final rule also retains the text from the proposal that expressly states that plan fiduciaries are not permitted to sacrifice investment return or take on additional investment risk to promote non-pecuniary benefits or any other non-pecuniary goals, but has been revised to include text from proposed paragraph (b)(1)(iii), modified slightly, that a fiduciary may not subordinate the interests of the participants and beneficiaries in their retirement income or financial benefits under the plan to other objectives. Even commenters that opposed the Department's proposal generally agreed that such a provision appropriately described a fiduciary's duty of loyalty under ERISA.<sup>36</sup>

With respect to the provisions of paragraph (c) of the proposal that would have separately required compliance with prudence obligations set forth in paragraph (b) (e.g., that the weight given to any particular pecuniary factors should appropriately reflect a prudent assessment of their impact on risk and return, and that fiduciaries considering pecuniary factors examine the level of diversification, degree of liquidity, and the potential risk-return in comparison

2019), [www.wsj.com/articles/a-users-guide-to-the-esg-confusion-11573563604](http://www.wsj.com/articles/a-users-guide-to-the-esg-confusion-11573563604) ("It's hard to move in the world of investment without being bombarded by sales pitches for running money based on 'ESG'"); Mark Miller, *Bit by Bit, Socially Conscious Investors Are Influencing 401(k)'s*, *New York Times* (Sept. 27, 2019), [www.nytimes.com/2019/09/27/business/esg-401k-investing-retirement.html](http://www.nytimes.com/2019/09/27/business/esg-401k-investing-retirement.html).

<sup>36</sup> The language in proposed (b)(1)(iii) referred to "unrelated objectives," rather than "other objectives." The Department has used "unrelated objectives" in previous sub-regulatory guidance. However, that language could be misconstrued as providing a loophole to allow fiduciaries to consider and to subordinate participants and beneficiaries' financial interests to objectives that are in any way related to the interests of participants and beneficiaries in their retirement income or financial benefits under the plan. It was not the Department's intent—and nor would it be consistent with ERISA—to allow fiduciaries to subordinate the interests of participants and beneficiaries in their retirement income or financial benefits under the plan to any other objective, and the Department has revised the language used in the final rule text to ensure that it is not misconstrued.

with other available alternative investments that would play a similar role in their plans' portfolios), the Department agrees with the observation of one commenter that identifying these requirements separately in paragraph (c)(1) and tying them to regulatory text about "environmental, social, corporate governance, or other similarly oriented factors" could be misconstrued as applying these general prudence criteria in some unique (or at least more rigorous) fashion to ESG and "other similarly oriented" investment strategies. Accordingly, in order to avoid redundant and potentially confusing regulatory requirements, the specific provisions on those obligations that were in paragraph (c) of the proposal have been eliminated from paragraph (c) of the final rule and replaced with a more general requirement that the weight given to any pecuniary factor by a fiduciary should appropriately reflect a prudent assessment of its impact on risk and return. As modified, this provision will provide fiduciaries the necessary flexibility to evaluate and consider the particular pecuniary factors relevant to a specific investment or investment course of action, while focusing paragraph (c) on the principal objective of adding to the regulation an express provision that the duty of fiduciaries is to act with an eye single toward furthering participants' "financial" rather than "nonpecuniary" benefits.

Further, the Department did not intend the reference to "generally accepted investment theories" to foreclose ERISA fiduciaries from considering emerging theories regarding prudent investment practices or otherwise freeze investment practice as of the date of the rule. Rather, the intent was to establish a regulatory guardrail against situations in which plan investment fiduciaries might be inclined to use, as one example, policy-based metrics in their assessment of the pecuniary value of an investment or investment plan that are inherently biased toward inappropriate overestimations of the pecuniary value of policy-infused investment criteria. The Department intended to communicate the idea that the fiduciary is required to have a soundly reasoned and supported investment decision or strategy to satisfy the ERISA prudence requirement. However, the Department has decided not to include this provision in the final rule, but rather to rely on the definition of pecuniary factor as the governor for investment decisions without specifically constraining the criteria that a fiduciary

<sup>35</sup> See, e.g., James MacKintosh, *A User's Guide to the ESG Confusion*, *Wall Street Journal* (Nov. 12,

could consider in making a prudent judgment. Although not retained as express regulatory text in the final rule, the Department believes that it would be consistent with ERISA and the final rule for a fiduciary to treat a given factor or consideration as pecuniary if it presents economic risks or opportunities that qualified investment professionals would treat as material economic considerations under generally accepted investment theories. In this regard, it is based on the essence of the 1979 investment duties regulation, the conditions of which basically require the judgment of a prudent expert—and if the decision maker does not have the expertise himself, he should consult such an expert. For example, in a 1996 letter to Eugene Ludwig, Comptroller of the Currency, regarding the ERISA duty of prudence in the context of an evaluation of the prudence of derivative investments, the Department stated that among other things, the fiduciary should determine whether it possesses the requisite expertise, knowledge, and information to understand and analyze the nature of the risks and potential returns involved in a particular derivative investment. The letter pointed out that the fiduciary must determine whether the plan has adequate information and risk management systems in place given the nature, size, and complexity of the plan's investment activity, and whether the plan fiduciary has personnel who are competent to manage those systems.<sup>37</sup>

The Department also did not intend that the provision be read, as some commenters did, as a limitation on the ability of ERISA fiduciaries to consider all relevant factors in evaluating whether factors may have a “material effect on the return and risk of an investment.” Rather, when comparing investment or investment courses of action, including selection of designated investment alternatives in the case of participant-directed individual account plans, a fiduciary satisfies its obligations under paragraph (c)(1) by evaluating factors that are expected to result in a material difference among reasonably available alternatives with respect to risk and/or return. Thus, the final rule neither specifically prohibits nor permits the use of proprietary products, fee sharing, and fee aggregation, but requires the fiduciary to evaluate whether such practices are expected to have a material effect on risk and/or

return as compared to the reasonably available alternatives. If a fiduciary were to prudently conclude that a fund manager's brand or reputation will materially affect the expected risk and/or return as funds, then such factors would be pecuniary. Similarly, to the extent that the net expenses incurred by the plan, such as for plan administration or to develop disclosures that are easier for participants to understand, are expected to materially affect the risk and return of one alternative as compared to another, such factors would be considered pecuniary. Finally, in response to some commenters, the Department did not intend to imply in the proposal that, in evaluating investments or investment courses of action, a fiduciary must always select the one with the lowest cost. Depending on the facts and circumstances, a fiduciary may conclude that a particular investment or investment course of action is prudent even though it entails higher risk or cost.

The Department, however, cautions fiduciaries against too hastily concluding that ESG-themed funds may be selected based on pecuniary factors or are not distinguishable based on pecuniary factors, thereby triggering the tie-breaking provision of paragraph (c)(2) of the final rule. A number of commenters touted the performance of ESG-themed funds for selected time periods, particularly after the widespread COVID-19 outbreak, as compared to more conventional alternatives. However, questions have been raised as to whether such performance was caused by a particular ESG strategy or merely correlated with broader economic trends unrelated to a specific ESG factor. The Department observes that many ESG-themed funds have been over-weighted in technology and underweighted in energy as compared to more conventional alternatives, which has affected certain funds' returns in recent periods. Technology assets performed relatively better during the recent pandemic, while energy markets that were already in turmoil from global excess supply declined further due to widespread decrease in demand, including due to reductions in travel. This difference in portfolio composition can affect the level of risk associated with the corresponding return and a fiduciary would need to prudently balance such considerations when comparing alternatives.

In response to the commenter who suggested that the definition of “pecuniary factor” should be modified to include a “reasonably be expected” provision, the Department has revised

the definition to mean a factor that a fiduciary prudently determines is expected to have a material effect on risk and/or return of an investment based on appropriate investment horizons consistent with the plan's investment objectives and the funding policy established pursuant to section 402(b)(1) of ERISA. The Department believes that a prudent determination incorporates a reasonableness standard of care, but has revised the definition to use terminology that is more consistent with the statutory language of ERISA section 404(a)(1)(B), which includes more than reasonableness. Thus, the final rule recognizes that the nature of the fiduciary investment judgments will necessarily involve forward-looking expectations when evaluating investment alternatives and strategies. The Department is also retaining the concept of materiality in the definition of “pecuniary factor” as it believes that fiduciaries and investment managers are generally familiar with that concept from its use in connection with both ERISA and the Federal securities laws.

With respect to the consideration of how the final rule and its emphasis on pecuniary factors would influence the selection of company stock for a plan, the Department notes first that commenters should not have concern on this issue. The basic ERISA principles governing fiduciaries have coexisted with the use of ESOPs for many years, and this rule does not disturb them. This rule is focused on principles of pecuniary and nonpecuniary investing in the broader marketplace. This rule does not have as one of its objectives any changes to the long-established use of ESOPs by companies that wish to do so.

Second and relatedly, the Department recognizes that ESOPs are typically set in most respects by the employer's settlor function, and further that they are congressionally sanctioned under a particularized statutory framework compatible with this rule. Most acquisitions of company stock and use of company stock funds in individual account plans are directed by the plan or instruments governing the plan. Investments in qualifying employer securities are explicitly authorized by statutory provisions in ERISA, and subject to specific statutory conditions that Congress enacted as elements of Federal employee benefits law. For example, there are specific provisions for employer securities in the requirements under ERISA section 101(i) related to notice of blackout periods to participants or beneficiaries under individual account plans. Section 101(m) includes special disclosure rules

<sup>37</sup> See Letter to Eugene A. Ludwig from Olena Berg (March 21, 1996), and also Advisory Opinions 2002-14A and 2006-08A; and Letter to J. Mark Iwry (Oct. 23, 2014).

for individual account plans on the right to divest employer securities with respect to any type of contribution. Section 105 on individual benefit statements requires individual account plans to include an explanation, written in a manner calculated to be understood by the average plan participant, of the importance, for the long-term retirement security of participants and beneficiaries, of a well-balanced and diversified investment portfolio, including a statement of the risk that holding more than 20 percent of a portfolio in the security of one entity (such as employer securities) may not be adequately diversified. Section 204(j) of ERISA includes special diversification requirements for certain individual account plans governing investments in employer securities. ERISA sections 404(a)(2) and 407 provide specific rules for the application of ERISA's diversification requirements to the acquisition of "qualifying employer securities." The U.S. Supreme Court has concluded that there is no special presumption of prudence under ERISA favoring ESOP fiduciaries, stating that "the same standard of prudence applies to all ERISA fiduciaries, including ESOP fiduciaries, except that an ESOP fiduciary is under no duty to diversify the ESOP's holdings."<sup>38</sup> Similarly, the duties of prudence and loyalty set forth in this regulation apply in the context of the pertinent provisions of ERISA. In short, the statutory provisions in ERISA, and others in the Internal Revenue Code, make clear that plan fiduciaries are permitted to invest in employer securities following the direction of a plan document with respect to acquisitions or holding of employer stock,<sup>39</sup> provided the fiduciary satisfies the applicable conditions in the statute, and acts prudently and loyally.

With respect to the comments by the multiemployer plan community requesting that the Department adjust its definition of pecuniary factor to include

increased contributions to plans as a result of investments, the Department has previously addressed this and similar issues in a number of advisory opinions and information letters.<sup>40</sup> Specifically, the Department has repeatedly explained that increased plan contributions and similar factors are not economic factors, but that they are the type of non-economic factor that may be considered where a fiduciary is permitted to make an investment decision on the basis of a non-pecuniary factor.<sup>41</sup> Increasing plan contributions and similar factors do not assist a fiduciary in determining the expected return on or riskiness of an investment, as plan contributions do not constitute a "return" on investment.

The Department's position on this issue has not changed and as a result we disagree with these commenters. The potential for increased contributions to a plan as a result of an investment is not a pecuniary factor associated with the return on a particular investment. Nor may increased contributions be considered a return on an investment. In terms of determining what is or is not a pecuniary factor, the relevant performance to be measured is that of the investment in question, not future plan contributions. The purpose of plan investments under ERISA is to provide and protect retirement benefits—not to strengthen employers or unions or provide job security. Under ERISA, plans are to be operated solely in the interest of participants and beneficiaries *as participants and beneficiaries*, not in some other role or capacity, such as union members, employees, or members of some other interest group. However, the Department agrees—consistent with the advisory opinions and information letters referenced above—that an objective to increase contributions or respond to participant interest in investment options for their retirement savings are permissible factors to use in the tie-breaker provisions in paragraph (c)(2), discussed below, based on their connection to the interests of the plan and plan participants and beneficiaries.

Finally, the Department does not agree with the position that ERISA

permits or requires plan fiduciaries to premise investment decisions on the idea that, as investors, they own a share of the world economy, and, therefore, that their financial interests demand that they adapt their investment-related actions to promote a theoretical benefit to the world economy that might redound, outside the plan, to the benefit of the participants in the plan.<sup>42</sup> The Department has acknowledged in the proposal and in this final rule that particular environmental or social factors may present material and current business risks or opportunities for specific companies (and may be reflected in potential market risk and return). But the Department cannot reconcile the approach described above with the requirements of prudence and loyalty under ERISA. On the contrary, that approach and the potential consequences of advocacy to plan fiduciaries based on that approach is one of the concerns that underlies this final rule, and illustrates why the Department considers the rule to be warranted at this time. As the Department has stated, it does not ineluctably follow from the fact that an investment promotes ESG factors, or that it arguably promotes positive general market trends or industry growth, that the investment is a prudent choice for retirement or other investors. Rather, ERISA fiduciaries must always put first the economic interests of the plan in providing retirement benefits. A fiduciary's evaluation of the economics of an investment should be focused on financial factors that have a material effect on the return and risk of an investment based on appropriate investment horizons consistent with the plan's articulated funding and investment objectives.

### 3. Section 2550.404a-1(c)(2)—Choosing Between or Among Investment Alternatives That the Plan Fiduciary Is Unable to Distinguish on the Basis of Pecuniary Factors Alone

Prior to the proposal, the Department's interpretive guidance provided that if, after an evaluation, alternative investments appear economically indistinguishable, a fiduciary may then, in effect, "break the tie" by relying on a non-pecuniary factor. The proposal carried forward this idea and paragraph (c)(2) of the proposal was designed to guide application of the "all things being equal" test by requiring fiduciaries to adequately document any such occurrences. In the preamble to the proposal, the Department noted that there are highly

<sup>38</sup> *Dudenhoeffer*, 573 U.S. at 418–419.

<sup>39</sup> The Department has taken the position that there is a class of activities that relate to the formation, rather than the management, of plans. These activities, generally referred to as settlor functions, include decisions relating to the formation, design, and termination of plans and, except in the context of multi-employer plans, generally are not activities subject to Title I of ERISA. As such, decisions that are settlor functions would not be subject to the final rule provisions that govern fiduciary investment duties. The Department notes, however, that actions taken to implement settlor decisions may involve fiduciary activities, and, to the extent those activities involve fiduciary investment decisions, they would be subject to the provisions of this final rule. See Advisory Opinion 2001–01A; Advisory Opinion 97–03A; Letters to Kirk Maldonado from Elliot Daniel (March 2, 1987); and Letter to John Erlenborn from Dennis Kass (March 13, 1986).

<sup>40</sup> See, e.g., DOL Inf. Ltr. to George Cox (Jan. 16, 1981); DOL Adv. Op. to Theodore Groom (Jan. 16, 1981); DOL Adv. Op. to Daniel O'Sullivan, Union Labor Life Ins. Co. (Aug. 2, 1982); DOL Adv. Op. to James Ray, Union Labor Life Ins. Co. (July 8, 1988); DOL Inf. Ltr. to Stuart Cohen, General Motors Corp. (May 14, 1993).

<sup>41</sup> See, e.g., DOL Inf. Ltr. to Ralph Katz (March 15, 1982) ("A decision to make an investment may not be influenced by a desire to stimulate the construction industry and generate employment, unless the investment, when judged solely on the basis of its economic value to the plan, would be equal or superior to alternative investments available to the plan.").

<sup>42</sup> See also *supra* at 83–84.



correlated investments and otherwise very similar ones. The Department observed that seldom, however, will an ERISA fiduciary consider two investment funds, looking only at objective measures, and find the same target risk-return profile or benchmark, the same fee structure, the same performance history, and the same investment strategy, but a different underlying asset composition. The Department explained that, even then, those two alternatives may function differently in the overall context of the fund portfolio and going forward may perform differently based on external economic trends and developments.<sup>43</sup> As a result, the Department expressed concern that the “all things being equal” test could invite fiduciaries to find ties without a proper analysis in order to justify the use of non-pecuniary factors in making an investment decision. Nonetheless, because it appeared that some form of ties may theoretically occur, and the Department did not have sufficient evidence to say they do not occur in fact, the Department proposed to retain a version of an “all things being equal” test. However, in the proposal, the Department specifically requested comment on the tie-breaker concept, whether true ties exist, and, if they do, how fiduciaries may appropriately break ties.

The Department also believed that using non-pecuniary factors to choose among investments merited closer scrutiny. As one commenter noted, trust fiduciary law recognizes that there are circumstances, mainly in the context of conditionally permitted conflicts of interest, that call for enhanced scrutiny of the substance of the fiduciary’s decision.<sup>44</sup> The Department believes that relying on non-pecuniary factors to select among investments is a circumstance that similarly warrants some form of enhanced scrutiny. Thus, paragraph (c)(2) of the proposal was designed to guide application of the “all things being equal” test by requiring fiduciaries to adequately document any such occurrences. If, under proposed paragraph (c)(2) after completing an appropriate evaluation, alternative investments appear economically indistinguishable, and one of the investments is selected on the basis of a non-pecuniary factor or factors such as environmental, social, and corporate governance considerations, the fiduciary must document why pecuniary factors

were not sufficient to select the investment or investment courses of action, how the investment compares to alternative investments with respect to the factors listed in paragraphs (b)(2)(ii)(A) through (C), and how the non-pecuniary factor or factors was chosen based upon the purposes of the plan, the diversification of investments, and the interests of the participants and beneficiaries in receiving benefits from the plan. The Department included the documentation requirement to provide a safeguard against the risk that fiduciaries will improperly find economic equivalence and make decisions based on non-pecuniary factors without a proper analysis and evaluation.

Many commenters characterized proposed paragraph (c)(2) of the proposal as a new stricter “tie breaker” or “all things being equal test” that was inappropriately rigid. One commenter asserted that proposed paragraph (c)(2) effectively required plan fiduciaries to demonstrate that the chosen investment was “outright superior” to the available alternative investments. Many commenters stated that the standard in the Department’s interpretive guidance was an easier standard to comply with and required the comparison only of investments of comparable financial value. Some commenters stated that the proposal appeared to require that the alternatives under consideration have “the same target risk-return profile or benchmark, the same fee structure, the same performance history, same investment strategy, [and that it not] function differently in the overall context of the fund portfolio, and [not] perform differently based on external economic trends and developments.” In short, the commenters argued the prior standard, which they said is best characterized as functional equivalence, was replaced with a new, more restrictive economically identical standard. These commenters asserted that the impossibility of satisfying this standard suggested that the Department’s objective in designing the provisions was to deter fiduciaries from considering investments with non-pecuniary benefits.

Some commenters argued that true “ties” of the sort envisioned in the proposal do not exist because they read the proposal as requiring investments to have identical characteristics, not just equivalent roles in the plan’s investment portfolio. They argued that such indistinguishability in liquid markets is all but impossible. The risk of any two assets, even if identical on some risk metric, will nonetheless not be perfectly correlated. Further, they

argued that breaking the tie is not the correct response. Rather, if there is no liquidity constraint and trading costs are low, they assert that textbook financial economics teaches that in the event of two economically equivalent investments so defined, the investor should buy both of them and achieve improved diversification.

Other commenters said that “ties” are actually quite common in the investment process and that for almost every portfolio, there are some economically indistinguishable alternatives when viewed in terms of the role the investments would play in the plan’s portfolio. The commenters argued that two or even several investments’ expected overall economic impact on a plan may be essentially the same even if the investments’ risk-return profile, fee structure, performance history, and investment strategy are not each literally identical. Some mutual fund commenters suggested that the proposal appears to assume that evaluation of two alternative investments based solely on pecuniary factors can be reduced to a single number. That assumption, they asserted, underestimates the complexity of portfolio construction.

Some commenters said that putting the burden on the fiduciary to justify a finding of economic equivalence that would permit a non-pecuniary tie-breaker is an appropriate policy response. They claimed there is considerable opportunity in the assessment of investment alternatives for those with an incentive to favor an ESG plan to nudge the process so that a slightly economically inferior ESG investment could be considered “economically indistinguishable” from a non-ESG alternative.

Other commenters argued that the tie-breaker idea should be available to fiduciaries when selecting investment alternatives for defined contribution plans. Those commenters argued that applying the tie breaker test to investment choices with the same overall economic role and impacts in a plan’s portfolio, within a reasonable range of expected outcomes, rather than only those that are identical in each and every respect (except for asset composition), would more appropriately reflect the process by which ERISA fiduciaries select plan investments.

Some commenters claimed that the proposal was vague and nonspecific as to what form the additional documentation required under proposed paragraph (c)(2) should take. Further, the commenters asserted, prudent plan fiduciaries already document their decision-making process. Other

<sup>43</sup> See Schanzenbach & Sitkoff, *supra* note 5, at 410 (describing a hypothetical pair of truly identical investments as a “unicorn”).

<sup>44</sup> See, e.g., Restatement (Third) of Trusts section 37 cmt. f(1) (2007) (“especially careful scrutiny”).

commenters asserted that no other Federal regulator mandates this much documentation. One commenter noted that there is no ESG documentation for investment managers under the Investment Advisers Act or the Investment Company Act. The commenter said the SEC Regulation Best Interest provides significant flexibility by leaving it largely up to individual firms to determine how best to memorialize decisions. Commenters asserted that although the Department explained in the preamble that the documentation safeguards against fiduciaries making decisions based on non-pecuniary factors without proper analysis or rigor, a lack of rigor is not synonymous with a lack of writing and does not explain why ESG factors are treated differently than other investment factors. Commenters also asserted that the proposed rule's documentation requirement would effectively create a unique and unwarranted presumption against ESG investing that does not apply to any other kind of investment. Some commenters asserted that the proposed rule if implemented would add new costs and these new costs would chill sponsors from considering any investment incorporating ESG factors, even if pecuniary and part of the risk assessment of the investment. Some commenters argued that paragraph (c)(2) would result in additional documentation burdens on plans that did not actually rely on the tie-breaker because fiduciaries would feel compelled to document ESG risk-reward integration as non-pecuniary collateral consideration for strategies in order to protect against second-guessing about the fiduciary's determination that the ESG factor was properly treated as a pecuniary factor. Some commenters stated that by requiring the documentation the proposed regulation would invite manufactured breach-of-fiduciary-duty lawsuits based on claimed documentation failures even in cases where there was no evidence of a failure in fiduciary decision-making.

Another commenter called for the documentation requirement to be expanded. The commenter argued that paragraph (c)(2) of the proposal, while a valuable addition, would not capture situations in which plan managers who are inclined toward policy-based investment have used policy-based metrics in their evaluation of the pecuniary value of an investment or investment plan that are inherently biased toward inappropriate overestimations of the pecuniary value of policy-infused investment decisions. This commenter suggested that the

requirement be expanded to require complete explanation and documentation any time policy-based analysis plays any role in the determination of the anticipated pecuniary value of an investment or investment strategy.

Fiduciaries are not compelled to break ties on the basis of non-pecuniary factors, and—consistent with their core obligation to discharge their duties solely in the interests of participants and beneficiaries—fiduciaries are encouraged to make their best judgment on the basis of pecuniary factors alone, or where prudent to diversify by selecting all indistinguishable alternatives. As described in the proposal and above, proposed paragraph (c)(2) is intended to provide a safeguard against the possibility that fiduciaries interested in making policy-based investments would improperly find economic equivalence and make decisions based upon non-pecuniary benefits without proper analysis and evaluation.

The Department does not agree that the final rule should adopt what some commenters referred to as a less restrictive “all things being equal” test. However, the Department notes there was disagreement among commenters as to whether true ties actually occur, and a great deal of confusion as to the meaning of “economically distinguishable” and whether that requires mathematical precision in the evaluation of investment characteristics that is unrealistic with respect to how investment professionals operate. After considering the public comments, the Department is persuaded that the tie-breaker test should be simplified and focus on situations in which the fiduciary is unable to distinguish investment alternatives on the basis of pecuniary factors alone, rather than demanding that investments be identical in each and every respect before the tie-breaker provision would be available.

The Department remains convinced, however, that it is appropriate for the regulation to include a safeguard against the risk that fiduciaries will improperly find economic equivalence and make decisions based on non-pecuniary factors without a proper analysis and evaluation. The Department thus decided to retain, with some modifications, the documentation requirements as part of the “all things being equal” test in paragraph (c)(2). The Department does not believe those requirements prohibit investments with non-pecuniary ESG or other components. Moreover, because the final rule does not require any

documentation of decisions that use pecuniary ESG factors, the Department does not believe that it will inappropriately chill fiduciaries from considering investments that incorporate ESG factors that can be shown to be pecuniary as part of the investment's risk assessment relative to non-ESG factors. In other words, the final rule does not single out ESG investing or any other particular investment theory for particularized treatment.

Rather, and specifically, paragraph (c)(2) of the final rule provides that if a fiduciary is unable to determine which investment is in the best interests of the plan on the basis of pecuniary factors alone, the fiduciary may base the investment decision on non-pecuniary factors, provided the fiduciary documents the following: why pecuniary factors were not sufficient to select the investment or investment course of action; how the investment compares to the alternative investments with regard to the factors listed in paragraphs (b)(2)(ii)(A) through (C); and how the chosen non-pecuniary factor or factors are consistent with the interests of the participants and beneficiaries in their retirement income or financial benefits under the plan. With respect to the third documentation requirement, the Department has consolidated the proposed requirement to document why the selected investment was chosen based on the purposes of the plan and the interests of plan participants and beneficiaries in receiving benefits from the plan into a single requirement. When a fiduciary makes an investment decision based on non-pecuniary factors as permitted under the final rule, the fiduciary remains subject to ERISA's general loyalty obligation and must act in a manner that is consistent with the interests of participants and beneficiaries in their retirement income or financial benefits. For example, responding to participant demand in order to increase retirement plan savings or investments in contribution creating jobs for current or future plan participants may be consistent with the interests of participants and beneficiaries in their retirement income or financial benefits under the plan, while selecting based on which investment would bring greater personal accolades to the chief executive officer of the sponsoring employer, or solely on the basis of a fiduciary's personal policy preferences, would not.

The proposal did not expressly incorporate the tie-breaker provision in paragraph (c)(2) on “economically indistinguishable alternative investments” into the regulatory

provision on selection of investment options for individual account plans. The Department explained in the proposal that it was of the view that the concept of “ties” may have little relevance in the context of fiduciaries’ selection of menu options for individual account plans as such investment options are often chosen precisely for their varied characteristics and the range of choices they offer plan participants. Further, the Department explained that because the proposal did not restrict the addition of prudently selected, well managed investment options for individual account plans which include non-pecuniary factors if they can be justified solely on the basis of pecuniary factors, there would be little need for a tie-breaker between selected investment funds. Nonetheless, some commenters expressed some uncertainty regarding the interaction of paragraph (c)(2) and the provisions of the proposal on selecting investment options for individual account plans. Some commenters asked the Department to expressly make the tie-breaker available for such investment decisions. The Department continues to doubt that the concept of a “tie” when adding designated investment alternatives to a platform of investments that allow participants and beneficiaries to choose from a broad range of investment alternatives as defined in 29 CFR 2550.404c-1(b)(3) is relevant. Nevertheless, the final rule makes the tie-breaker provisions in paragraph (c) generally available for use in selecting investment options for individual account plans in the event the fiduciaries of the plan believe that it gives them some added flexibility and protection when adding an investment fund, product, or model portfolio that promotes, seeks, or supports one or more non-pecuniary goals in circumstances where the fiduciary could not distinguish such investment option from an alternative on the basis of pecuniary factors alone.

#### 4. Section 2550.404a-1(d)—Investment Alternatives in Participant-Directed Individual Account Plans

Paragraph (c)(3) of the proposed rule contained standards applicable to participant-directed individual account plans. Participant-directed plans are a subset of individual account retirement plans that provide for the allocation of investment responsibilities to participants and beneficiaries of the plans, sometimes referred to as “self-directed” plans. Paragraph (c)(3) of the proposal, in relevant part, stated the general proposition that sections 403 and 404 of ERISA apply to a fiduciary’s

selection of an investment fund as a designated investment alternative in an individual account plan.

Paragraph (c)(3) of the proposal further provided that a fiduciary’s addition (for the platform) of one or more prudently selected, well managed, and properly diversified investment alternatives that include one or more environmental, social, corporate governance, or similarly oriented assessments or judgments in their investment mandates, or that include these parameters in the fund name, would not violate the standards in section 403 and 404 provided three conditions were met. The first condition, at paragraph (c)(3)(i) of the proposed rule, was that the fiduciary uses only objective risk-return criteria, such as benchmarks, expense ratios, fund size, long-term investment returns, volatility measures, investment manager investment philosophy and experience, and mix of asset types (e.g., equity, fixed income, money market funds, diversification of investment alternatives, which might include target date funds, value and growth styles, indexed and actively managed funds, balanced and equity segment funds, non-U.S. equity and fixed income funds), in selecting and monitoring all investment alternatives for the plan including any environmental, social, corporate governance, or similarly oriented investment alternatives. The second condition, at paragraph (c)(3)(ii) of the proposed rule, was that the fiduciary must document its compliance with the first condition. The third condition, at paragraph (c)(3)(iii) of the proposed rule, was that the environmental, social, corporate governance, or similarly oriented investment mandate alternative is not added as, or as a component of, a qualified default investment alternative described in 29 CFR 2550.404c-5.

Paragraph (d) of the final rule contains standards applicable to participant-directed individual account plans. The standards in paragraph (d) of the final rule reflect substantial revisions from the proposed rule. The predecessor provisions in paragraph (c)(3) of the proposal are revised, reorganized, and relocated into paragraph (d) of the final rule in response to concerns raised by the public commenters.<sup>45</sup> As in the proposal, the final rule’s paragraph (d)

is a legal requirement and not a safe harbor.

Paragraph (d)(1) of the final rule provides that the standards set forth in paragraph (a) (relating to the statutory duties of loyalty and prudence) and paragraph (c) (the pecuniary-only and anti-subordination provisions, including the tie-breaker test) of the final rule apply to a fiduciary’s selection of designated investment alternatives that will be made available to participants and beneficiaries for investing their individual accounts. This provision makes clear that the same prudence and loyalty duties that apply generally to evaluating investments under ERISA (such as stock selection) also apply to a fiduciary’s evaluation and selection of designated investment alternatives from which participants and beneficiaries select where to direct their retirement assets. Thus, 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.

Paragraph (d)(1) of the final rule responds to commenters who objected to what they perceived as the proposal’s establishment of stricter or different rules for self-directed individual account plans than for all other types of plans. For instance, a number of commenters on the proposal questioned the relationship between the “objective-criteria only” standard in paragraph (c)(3)(i) of the proposal, and the “pecuniary only” standard in paragraph (c)(1) of the proposal. The commenters argued that these two standards did not harmonize with each other, and that their overlay was unnecessarily protective and would have created ambiguity or possibly even inconsistency. This concern was generated, in part, by the fact that some of the listed examples of permissible objective criteria were seen as neither “objective” nor pecuniary, according to the commenters. Many commenters also questioned the accuracy of the list of objective criteria contained in the paragraph (c)(3)(i) of the proposal, with some commenters suggesting additions and other commenters suggesting deletions. A number of commenters also strongly objected to the objectivity standard on the basis that it disfavors active investment strategies for self-directed plans, and that the Department should refrain from interfering in the

<sup>45</sup> For the reasons explained above in footnote 32, supra, the final rule no longer contains an explicit reference to section 403 of ERISA. This omission better aligns the scope of paragraph (d) of the final rule with the scope of paragraph (a) of the final rule.

investment marketplace by favoring or disfavoring any particular investment alternatives or strategies.

In response to these concerns, the final rule omits the “objective-criteria only” standard. The Department agrees that this standard, as structured in the proposal, was perhaps more restrictive than necessary and potentially confusing as to exactly how it was intended to relate to other proposed provisions subsequently removed from the proposal. The Department does not agree with the commenters, however, to the extent that their comments could be construed as suggesting that the duty of prudence does not apply to a fiduciary’s selection of designated investment alternatives for investment menus. Nor does the Department agree that a plan fiduciary need not consider objective risk-return criteria or need not document the selection and monitoring processes to comply with ERISA’s duty of prudence. Since the final rule makes it clear that ERISA’s duty of prudence (as contained in paragraph (a) of the final rule) and the pecuniary factor provisions in paragraph (c) of the final rule apply to the selection of designated investment alternatives that will be made available to participants and beneficiaries for investing their individual accounts, it is unnecessary to retain the “objective-criteria only” provisions from the proposal.

Paragraph (d)(1) of the final rule, moreover, responds to commenters who raised concerns with the ESG terminology in the introductory portion of paragraph (c)(3) of the proposal. The objected-to terminology made reference to investment alternatives “that include one or more environmental, social, corporate governance, or similarly oriented assessments or judgments in their investment mandates, or that include these parameters in the fund name.” The principal concern with this terminology, which operated as the triggering mechanism for the substantive requirements in paragraphs (c)(3)(i) through (iii) of the proposal, was that it improperly equated all ESG considerations with non-financial considerations, according to commenters. Greatly compounding this concern, according to the commenters, was that this terminology lacked sufficient clarity and definition to enable implementation and compliance by fiduciaries as well as the investment managers they oversee. The final rule does not contain this or similar terminology in paragraph (d)(1) or elsewhere. This omission makes it clear that the Department understands that at least some ESG factors, at times, may also be pecuniary factors.

Paragraph (d)(2) of the final rule reinforces the principles in paragraph (d)(1) by providing that a fiduciary is not automatically prohibited from considering or including an investment fund, product, or model portfolio merely because the fund, product, or model portfolio promotes, seeks, or supports one or more non-pecuniary goals, provided that the fiduciary satisfies the requirements of paragraphs (a) and (c) of this section in selecting any such investment fund, product, or model portfolio. This provision makes it clear that fiduciaries are indeed permitted to add, to platforms or menus, designated investment alternatives that may produce collateral benefits or otherwise are viewed by some as socially desirable. But, importantly, these alternatives may be added only if they can be justified solely on the basis of pecuniary factors. Fiduciaries who choose investments with expected reduced returns or greater risks to secure non-pecuniary benefits are in violation of ERISA. Thus, fiduciaries who are considering investment alternatives for individual account plans should carefully review the prospectus or other investment disclosures for statements regarding ESG investment policies and investment approaches. Fiduciaries should be particularly cautious in exercising their diligence obligations under ERISA when disclosures, whether in prospectuses or marketing materials, contain references to non-pecuniary factors or collateral benefits in a fund’s investment objectives or goals or its principal investment strategies.

With further regard to paragraph (d)(2) of the final rule, many commenters reported evidence of strong participant preference for investment alternatives that promote, seek, or support one or more non-financial goals. These commenters, moreover, suggested a positive correlation between the in-plan availability of such alternatives and increased participation and savings rates by participants in plans with such alternatives. For example, one commenter in the business of providing financial services cited research finding that 76 percent of consumers think it important for their employer to apply ESG principles to workplace benefits, and that 60 percent would likely contribute more to an ESG-aligned retirement plan if it were certified. Another commenter cited a 2018 GAO study finding that more than half of the asset managers interviewed stated that incorporating ESG factors into retirement plan investment options would help meet participant

expectations and increase participation, especially of younger investors.<sup>46</sup> Nothing in the final rule precludes a fiduciary from looking into certain types of investment alternatives in light of participant demand for those types of investments. But in deciding whether to include such investment options on a 401(k)-style menu, the fiduciary must weigh only pecuniary (as that term is defined in this rule) factors. Paragraph (d)(2) does not diminish the pecuniary-only standards in paragraph (c)(1) of the final rule; rather, it applies the principles in paragraph (c)(1) to the search for and selection of designated investment alternatives. In addition, participant preferences of the type discussed in this paragraph also can be directly relevant to compliance with the tie-breaking provision in paragraph (c)(2) of the final rule. In such tie-breaker scenarios, plan fiduciaries may consider the express demands or interests of plan participants to be consistent with the interests of participants and beneficiaries for purposes of the documentation requirement in paragraph (c)(2)(iii) of the final rule.

Paragraph (d)(2) of the final rule does not contain the documentation requirement that existed in paragraph (c)(3)(ii) of the proposal. That provision of the proposal would have required a fiduciary to document its compliance with the requirement, in paragraph (c)(3)(i) of the proposal, to use only objective risk-return criteria in the selection and monitoring of investment platform or menu alternatives. Some commenters objected to this requirement on the grounds that it would have applied more stringent requirements to ESG investment alternatives than other types of investment alternatives. These commenters argued that it is inappropriate to impose separate documentation requirements that vary by investment strategy. Other commenters objected to this requirement on the grounds that it would increase costs to plans and potentially provide grounds for unwarranted class action lawsuits. As discussed above, the final rule does not contain the “objectivity” test from paragraph (c)(3)(i) of the proposal. Therefore, the final rule similarly omits the related requirement to document compliance with that test.

Paragraph (d)(2)(ii) of the final rule provides special treatment for qualified

<sup>46</sup> Government Accountability Office Report No. 18–398, *Retirement Plan Investing: Clearer Information on Consideration of Environmental, Social, and Governance Factors Would Be Helpful* (2018).

default investment alternatives (QDIA or QDIAs) as defined in 29 CFR 2550.404c-5. As was more fully explained in the preamble to the proposed rule, QDIAs warrant special treatment because they are unique arrangements under ERISA that help ensure that the retirement savings of plan participants who have not provided affirmative investment directions for their individual accounts, e.g., because they may not be comfortable making such investment decisions, are put into a single investment capable of meeting the participant's long-term retirement savings needs. Indeed, the relevant provisions of ERISA and the Department's implementing regulations encourage plans to offer QDIAs by providing fiduciaries with relief from liability for investment outcomes by deeming a participant to have exercised control over assets in his or her account if, in the absence of investment direction from the participant, the plan fiduciary invests the assets in a QDIA. Thus, selection of an investment fund as a QDIA is not analogous to merely offering participants an additional investment alternative as part of a prudently constructed lineup of investment alternatives from which participants may choose.

The proposed rule, in relevant part, therefore provided that even a prudently selected, well managed, and properly diversified investment alternative could not be added as, or as a component of, a QDIA if the investment alternative included "one or more environmental, social, corporate governance, or similarly oriented assessments or judgments" in its "mandate" or included those parameters in the fund name. Thus, paragraph (c)(3)(iii) of the proposal would have banned any alternative containing this type of mandate from being a QDIA even if it was selected using only objective risk-return criteria and was otherwise prudent. This ban was limited to QDIAs and would not have affected an otherwise compliant alternative from being added to an investment platform or investment menu.

Many commenters interpreted paragraph (c)(3)(iii) of the proposal as a ban on any investment alternative serving as a QDIA if the investment alternative (or any component of the investment alternative) was constructed using any 'E', 'S', or 'G' factor even if such factor was pecuniary in nature, (i.e., it has a material effect on the risk and/or return of the investment based on an appropriate time horizon). That was not the Department's intention or, in the Department's view, a reasonable

reading of paragraph (c)(3)(iii) of the proposal. The intent behind that paragraph, rather, was to prohibit an investment alternative (or any component of the investment alternative) whose investment objectives or principal strategies included a non-financial goal from being a QDIA. Investment alternatives falling into this category often are referred to as "ESG-themed funds," "impact funds," "sustainability funds," "social funds," "society-first funds," and so on, according to the commenters.

The foregoing misinterpretation notwithstanding, some commenters supported a ban on any investment alternative serving as a QDIA if the investment alternative (or any component of the investment alternative) was constructed using ESG factors. According to these commenters, ESG is a vague and contradictory concept, ESG performance is difficult to measure and does not convey the same information as traditional performance measures, ESG investments may contain unidentified risks, many ESG funds do not execute on their stated principles, some ESG alternatives involve considerations other than purely economic considerations, and social issues are contentious and will vary across plan participants. Consequently, these commenters argued that allowing ESG funds to be included as, or as a component of, a QDIA could encourage plan participants to hold ESG investments that are either inappropriate or not consistent with their individual investment goals.

A number of commenters, however, were not supportive of paragraph (c)(3)(iii) of the proposal. Many commenters believe no special treatment is needed for QDIAs. If an investment alternative is chosen based only on pecuniary factors, according to these commenters, the alternative should be eligible to serve as a QDIA if it otherwise meets the requirements of the QDIA regulation. These commenters question why an otherwise compliant investment alternative, constructed only on the basis of sound pecuniary factors as defined in the proposal, should be per se ineligible to be a QDIA. Further, commenters were concerned that the breadth of the proscription in paragraph (c)(3)(iii) of the proposal, as they understood it, would be extremely disruptive to the market and that it might inadvertently result in a lack of available investment alternatives that could qualify as QDIAs, to the detriment of participants and beneficiaries of ERISA covered plans.

After considering the comments, the final rule limits the scope of the special

rule for QDIAs. Paragraph (d)(2)(ii) of the final rule expressly provides that in no circumstances may any investment fund, product, or model portfolio be "added as, or as a component of, a qualified default investment alternative described in 29 CFR 2550.404c-5 if its investment objectives or goals or its principal investment strategies include, consider, or indicate the use of one or more non-pecuniary factors."

Thus, by omitting all references to "environmental," "social," "corporate governance," and "similarly oriented" assessments and judgments, paragraph (d)(2)(ii) of the final rule clarifies that the special rule for QDIAs is not focused on whether an investment alternative employs or applies any particular 'E', 'S', or 'G' factors in operation. This omission responds directly to the many commenters who stated their belief that the proposal's use of these terms unhelpfully conflated financial and non-financial factors. In place of these terms, paragraph (d)(2)(ii) of the final rule focuses on whether the investment alternative includes, considers, or indicates the use of non-pecuniary factors in its investment objectives or goals or its principal investment strategies. This refocusing is an acknowledgement that individual 'E', 'S', and 'G' factors can be both pecuniary and non-pecuniary in nature, and that the selection of ESG funds is not per se prudent or imprudent.<sup>47</sup>

Accordingly, paragraph (d)(2)(ii) clarifies that the special rule for QDIAs only prevents a designated investment alternative, which otherwise satisfies the requirements in paragraph (d)(1) of the final rule, from being selected 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. These circumstances would trigger the ban in paragraph (d)(2)(ii) of the final rule against a particular designated investment alternative from being selected as a QDIA, even if the investment alternative could otherwise permissibly be selected as a designated investment alternative for the investment platform or investment menu by fiduciaries only on the basis of pecuniary factors.

In these circumstances, the Department agrees with those commenters who believe a heightened prophylactic approach for QDIAs is the best course of action. QDIAs by

<sup>47</sup> This acknowledgement does not change the Department's views expressed on ESG rating systems. See Section 8.e. of this preamble for further discussion on ESG ratings systems and comments received on them.

definition exist for participants and beneficiaries who do not actively direct their investments, and by operation tend to sweep in many participants and beneficiaries with less investment experience and sophistication than more active investors, according to the commenters. ERISA is a statute whose overriding concern relevant here has always been providing a secure retirement for America's workers and retirees, and it is inappropriate for participants to be defaulted into a retirement savings fund that may have other objectives absent their affirmative decision. This is especially true if the default investment alternative, or any of its components, has investment objectives or principal strategies that reflect one or more non-pecuniary factors. The use of non-pecuniary factors, even if co-existing with financially-oriented strategies or goals, raise questions as to the extent to which the QDIA's managers may be forgoing financial returns in pursuit of non-financial objectives.

The test in paragraph (d)(2)(ii) of the final rule can be applied objectively without difficulty. A plan fiduciary, for instance, can simply look at the investment fund's prospectus to determine whether the fund is subject to the prohibition on its use as a QDIA or as a component investment of a QDIA. Under the Investment Company Act of 1940, as amended,<sup>48</sup> investment companies and their managers have routinely dealt with the concepts underpinning the provisions in paragraph (d)(2)(ii) of the final rule, *i.e.*, providing disclosure on an investment alternative's "investment objectives" and "principal investment strategies." Under Form N-1A,<sup>49</sup> for example, to the extent that non-pecuniary considerations form a material part of a fund's investment objective or principal strategies, these factors would need to be disclosed accordingly in the fund's prospectus. For example, if the prospectus or similar disclosure states that the fund (or any component) is constructed using an ESG or sustainability rating system or index, and that ratings system or index evaluates one or more factors that are not financially material to investments (*i.e.*, evaluates non-pecuniary factors), then paragraph (d)(2)(ii) of the final rule would prohibit such fund from being used as a default investment alternative.<sup>50</sup> The Department

understands that the final rule applies to investment alternatives other than registered investment companies, such as bank collective investment trusts and insurance company separate accounts. However, these vehicles typically adhere to similar rules and maintain operating documents comparable to a prospectus.

Paragraph (d)(2)(ii) of the final rule also responds to concerns with so-called "screening strategies," which include, for example, the act of excluding from a fund certain sectors or companies involved in activities deemed unacceptable or controversial, such as screens or exclusions on investments in companies engaged in the production or distribution, for example, of alcohol, tobacco, fossil fuels, weapons, or gaming. Other screening strategies will only select sectors or companies that satisfy certain attributes, such as carbon emissions, board diversity, or employee compensation. Screening strategies, regardless of whether they are characterized or described as "positive screening" or "negative screening," may implicate paragraph (d)(2)(ii) of the final rule if the screening involves non-pecuniary factors that effectively results in the exclusion of certain sectors or categories of investments. Investment alternatives that use these exclusions may not be QDIAs (or components of QDIAs) if these exclusions involve non-pecuniary goals and are reflected in the investment alternatives' objectives or goals or its principal investment strategies. This is because such an exclusion in an investment alternative's objectives or principal strategies raises questions as to the extent to which the QDIA's manager may be foregoing financial returns in pursuit of non-financial objectives.

If these exclusions are not reflected in an investment alternative's objectives or principal strategies, however, the alternative is not prohibited as a QDIA (or a component). It must be prudently selected as required by paragraph (a) of the final rule, and comply with paragraph (c) of the final rule and the Department's QDIA regulation. ERISA's duty of prudence dictates that before a fiduciary of an ERISA covered pension plan can make a decision to exclude a category of investments for non-pecuniary purposes, the fiduciary must first make a determination that the exclusion of such category of investments would not reduce the return or increase the risk of the plan's investment portfolio. An investment policy or strategy that is exclusionary runs the risk of being imprudent because, if the decision results in the exclusion, for example, of certain

sectors or markets, without first doing an economic analysis of the economic consequences to the plan of such an exclusion and determining that such an exclusionary policy would not be economically harmful to the plan, the fiduciary making such a decision would be imprudent under ERISA.<sup>51</sup>

Finally, a commenter stated that, although paragraph (c)(3) of the proposal helpfully clarifies that ERISA's duties of loyalty and prudence apply to "designated investment alternatives," the final regulation should further clarify that these statutory duties (and, hence, the requirements of the final rule) do not apply more broadly to other investment alternatives that may be available through the plan. For instance, some participant-directed individual account plans contain brokerage windows, self-directed brokerage accounts, or similar plan arrangements that enable participants and beneficiaries to select investments beyond those designated by the plan. The commenter appears to have had these arrangements in mind and specifically requested that the final rule define the term "designated investment alternative" so as to exclude investments of this type from the requirements of the rule.

In response to this commenter, the final regulation defines the term "designated investment alternative" for purposes of paragraph (d) of the final rule. Specifically, paragraph (e)(5) of the final rule defines this term as "any investment alternative designated by the plan into which participants and beneficiaries may direct the investment of assets held in, or contributed to, their individual accounts." Thus, whether an investment alternative is a "designated investment alternative" for purposes of the regulation depends on whether it is specifically identified as available under the plan. This necessarily is a fact driven analysis. Further, the definition specifically clarifies that the term does not include "brokerage windows," "self-directed brokerage accounts," or similar plan arrangements that enable participants and beneficiaries to select investments beyond those designated by

<sup>51</sup> See Letter to Sen. Howard Metzenbaum from Dennis Kass (May 27, 1986) (defending statement in press that "an investment policy that is on its face exclusionary runs the risk of being on its face imprudent" and explaining that "before a fiduciary of an ERISA covered pension plan can make a decision to exclude a category of investments for social purposes, the fiduciary must first make a determination that the exclusion of such category of investments would not reduce the return or raise the risk of the plan's investment portfolio. If such a determination can be made, then social judgments as to the composition of the portfolio would be permissible.").

<sup>48</sup> 17 CFR 270.0-1 through 270.60a-1.

<sup>49</sup> Referenced at 17 CFR 239.15A and 274.11A.

See, *e.g.*, Item 2 and Item 4 of Part of Form N-1A.

<sup>50</sup> See Section 8.e. below, which further discusses ESG and similar rating systems and indexes.

the plan. The inclusion of this definition in the final rule also obviates the need for explicit references in the operative regulatory text to “platforms,” which appeared in the proposal essentially as a synonym for menus of designated investment alternatives.

Consequently, this regulation does not apply to investment alternatives that are not designated investment alternatives under the plan. The Department in other contexts has made it clear, however, that ERISA’s duties of loyalty and prudence do not contain exceptions for circumstances in which plans with brokerage windows, self-directed brokerage accounts, or similar plan arrangements enable participants and beneficiaries to select investments beyond those designated by the plan. For instance, in addressing questions under 29 CFR 2550.404a–5 (a disclosure regulation focusing on fees in 401(k)-type plans) in the case of participant-directed individual account plans that do not designate any of the funds on the platform or available through the brokerage window, self-directed brokerage account, or similar plan arrangement as “designated investment alternatives” under the plan, the Department stated that fiduciaries “are still bound by ERISA section 404(a)’s statutory duties of prudence and loyalty to participants and beneficiaries who use the platform or the brokerage window, self-directed brokerage account, or similar plan arrangement, including taking into account the nature and quality of services provided in connection with the brokerage window, self-directed brokerage account, or similar plan arrangement.”<sup>52</sup> In this same context, the Department also stated that a plan fiduciary’s failure to designate investment alternatives, for example, to avoid the standards and obligations under ERISA or implementing regulations raises questions under ERISA section 404(a)’s general statutory fiduciary duties of prudence and loyalty.<sup>53</sup> The Department has also stated in the context of the 404(c) regulation that the relief from fiduciary liability for participant or beneficiary exercises of control over their individual accounts does not extend to any instruction, which if implemented (A) would not be in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of title I of ERISA; (B) would cause a fiduciary to maintain the indicia of ownership of

any assets of the plan outside the jurisdiction of the district courts of the United States other than as permitted by section 404(b) of the Act and 29 CFR 2550.404b–1; (C) would jeopardize the plan’s tax qualified status under the Internal Revenue Code; or (D) could result in a loss in excess of a participant’s or beneficiary’s account balance. Similarly, relief from fiduciary liability under the 404(c) regulation would not extend to: (1) The implementation of instructions which would result in a direct or indirect sale, exchange, or lease of property between a plan sponsor or any affiliate of the sponsor and the plan except for the acquisition or disposition of any interest in a fund, subfund, or portfolio managed by a plan sponsor or an affiliate of the sponsor, or the purchase or sale of any qualifying employer security (as defined in section 407(d)(5) of the Act) which meets the conditions of section 408(e) of ERISA and 29 CFR 2550.404c–1(d)(2)(ii)(E)(4); (2) a loan or extension of credit to a plan sponsor or any affiliate of the sponsor; or (3) the acquisition or sale of any employer real property (as defined in section 407(d)(2) of the Act).<sup>54</sup> The Department has not addressed in these other contexts whether, or under what circumstances, the duties of prudence or loyalty compel a fiduciary to disregard or overrule a participant’s or beneficiary’s affirmative selection of a particular investment or investments through a brokerage window or similar arrangement, and these matters similarly are not addressed here. Accordingly, nothing in this regulation should be construed as addressing the application of ERISA’s duties of prudence and loyalty to such investments or to the particular investment options (e.g., brokerage windows) that grant participants and beneficiaries access to investments that are not designated investment alternatives. Although the Department has determined that the establishment of regulatory standards governing such arrangements is beyond the scope of this particular regulation, this issue could be addressed in future rulemaking or sub-regulatory guidance if necessary. The Department, therefore, is available as necessary to engage in discussions with interested parties to help determine how best to assure compliance with these duties in a practical and cost effective manner.

##### 5. Section 2550.404a–1(e)—Reserved

Paragraph (e) is reserved for the operative text, if finalized, of the rulemaking on proxy voting and exercise of shareholder rights.

##### 6. Section 2550.404a–1(f)—Definitions

Paragraph (f) of the final rule provides definitions and is largely unchanged from the proposal.

The term “investment duties” in the proposal was unchanged from the current 404a–1 regulation. It was defined to mean any duties imposed upon, or assumed or undertaken by, a person in connection with the investment of plan assets which make or will make such person a fiduciary of an employee benefit plan or which are performed by such person as a fiduciary of an employee benefit plan as defined in section 3(21)(A)(i) or (ii) of the Act. The term “investment course of action” is amended from the current 404a–1 regulation to mean any series or program of investments or actions related to a fiduciary’s performance of the fiduciary’s investment duties, and the selection of an investment fund as a plan investment, and now includes the selection of an investment fund as a plan investment, or in the case of an individual account plan, a designated alternative under the plan, as part of this term. One commenter noted that neither the definition of “investment duties” nor the definition of “investment course of action” expressly included the notion of stewardship activity and argued that the allocation of resources to voting, engagement, and related activity should be treated as an “action related to” the investment of plan assets. The commenter expressed that the focus on investment is less on the risks and returns of individual holdings and more on addressing systemic or “beta” issues such as climate change and corruption where outcomes are prioritized at the economy or society-wide scale with long-term, absolute returns for universal owners, including real-term financial and welfare outcomes for beneficiaries.

The Department does not see how it is possible for the stewardship approach advocated by the commenters to be justified, given the requirements of prudence and loyalty under ERISA. As the Department has stated, it does not ineluctably follow from the fact that an investment promotes ESG factors, or that it arguably promotes positive general market trends or industry growth, that the investment is a prudent choice for retirement investors. Rather, ERISA fiduciaries must always put first the economic interests of the plan in

<sup>52</sup> Field Assistance Bulletin 2012–02R, Q&A 39 (July 30, 2012).

<sup>53</sup> *Id.* at Q&A 39.

<sup>54</sup> See 29 CFR 2550.404c–1(d)(2) (imposing limits on the relief otherwise available to plan fiduciaries in the case of implementing improper investment instructions of participants and beneficiaries).



providing retirement benefits. A fiduciary's evaluation of the economics of an investment should be focused on financial factors that have a material effect on the return and risk of an investment based on appropriate investment horizons consistent with the plan's articulated funding and investment objectives.<sup>55</sup> Accordingly, as noted above, paragraphs (f)(1) and (2) of the final rule are the same as the language of the proposal.

The term "pecuniary factor" was a new definition in the proposal. The proposal defined it as a factor that has a material effect on the risk and/or return of an investment based on appropriate investment horizons consistent with the plan's investment objectives and the funding policy established pursuant to section 402(a)(1) of ERISA. Many commenters urged the Department to re-examine the definition of "pecuniary factor." The Department's discussion of those comments is included in the section of this preamble that addresses paragraph (c)(1) above.

Finally, the term "plan" was unchanged from the current 404a-1 regulation. It was defined in the proposal to mean an employee benefit plan to which Title I of ERISA applies. Although not commenting specifically on the proposal, some commenters raised issues regarding the consequences for plans maintained for their employees by states, political subdivisions of states, and the agencies or instrumentalities of either. Section 4(b)(1) of ERISA excludes from coverage under ERISA all such governmental plans. Accordingly, issues regarding the investment practices of such plans or the duties of persons who may be fiduciaries with respect to such plans are outside the scope of both the Department's jurisdiction under Title I of ERISA and this regulation.

Some commenters suggested that the Department define "ESG," "ESG vehicle," "ESG consideration," or any other similar term, and "environmental," "social," or "corporate governance," or give guidance on what might be "similarly oriented assessments or judgments." These commenters argued that without an ESG definition, fiduciaries would be left in the undesirable position of being unable to determine exactly what the Department seeks to regulate and the scope of that regulation, opening the door to expensive litigation that seeks to exploit those ambiguities. Other commenters stated that a definitive list of ESG issues does not exist and that it

would not be possible or desirable to produce a list or set of definitions, and any attempt at such list or definition would soon be outdated in any event. The same commenter said a definition of ESG was needed so that fiduciaries would know whether the Department intends for "ESG" to apply narrowly, such as with respect to only those investment alternatives that prominently call themselves "ESG," or if the Department intended to sweep in a much broader set of investment alternatives under "ESG," because the resulting impact, burden, expense, and collateral consequences of the proposed amendments could significantly differ. As described earlier in this preamble, the Department has concluded, based on the comments, that the use of ESG terminology is not appropriate for a regulatory standard precisely because of the ambiguity and lack of precision that exists in the use of ESG in the marketplace. Since the Department has removed ESG terminology from the operative text of the final rule, inclusion of the sort of definitions requested by commenters is no longer necessary.

#### *7. Section 2550.404a-1(g) and (h)—Effective Date and Severability*

The proposal included a provision under which the effective date for the rule would be a date 60 days after the date of the publication of the final rule. The Department requested comment in the proposal, including whether any transition or applicability date provisions should be added to any of the proposed provisions. Some commenters suggested that a grandfather provision of existing investments be adopted to avoid market disruption, including forced sales at sub-optimal prices. Other commenters said grandfathering is necessary not only because fiduciaries will be unable to comply retrospectively with prescriptive requirements, but also to avoid the wide-ranging economic harms that could follow a sudden investment mandate. The commenters suggested that, at a minimum, the provisions of the final rule would not apply to investments made on or prior to the effective date of any final regulation. In the alternative, the commenters requested that the Department permit those investments that have been made on or preceding such effective date not to become subject to the provisions of any final rule for a period of one year following such effective date. Other commenters suggested that this period of transition and grandfathering be generous. Other commenters suggested that the Department allow plan fiduciaries adequate time to prepare the

documentation and analysis required by the proposal to identify, assess, and consider alternative investment options in accordance with the proposal. These commenters believed the proposal greatly underestimated the time required for plan fiduciaries to consider and implement the new framework. As a result, they suggested that plan fiduciaries should be afforded at least 12 months before the rule becomes effective to mitigate hastened decision-making and potential financial losses resulting from modifying investment strategies that may inadvertently harm plan participants in the current volatile and uncertain market environment. Finally, a commenter suggested that due to COVID-19 and its financial fallout, the effective date should be delayed by at least a year to allow time for compliance.

The same principles of prudence and loyalty under section 404(a)(1)(A) and (B) of ERISA are on display in the proposal and final rule as have been applied in all the previous guidance on ESG investing and investing in general by the Department since the investment duties regulation was published in 1979. Indeed, since the 1980s the Department has stated that a fiduciary in its decision-making, regarding investments or otherwise, cannot subordinate the interests of the participants and beneficiaries in their retirement income or financial benefits under the plan to unrelated objectives. Following consideration of the public comments, the Department is not persuaded that there is sound reason to delay the anticipated benefits and protections to plan participants and beneficiaries of this rule. As the Department has previously stated, the final rule, including changes from the proposal, primarily explains existing statutory requirements and regulations with respect to the investment duties of plan fiduciaries and is not a major departure from its previous guidance on the basic investment duties of fiduciaries. Thus, the Department does not believe an overall delay in the applicability of the final rule is necessary to allow additional time for plans to prepare for the significantly scaled-back investment documentation requirements of the final rule.

However, the Department acknowledges that some plans may have to make adjustments to their investment policies and practices in light of the final rule. As a result, paragraph (g)(1) of the final rule provides that the effective date of the new regulatory text in the final rule will be 60 days following the date of publication in the **Federal Register** and shall apply

<sup>55</sup> See Field Assistance Bulletin 2018-01 (Apr. 23, 2018).

prospectively in its entirety to investments made and investment courses of action taken after such date. Plan fiduciaries are not required to divest or cease any existing investment, investment course of action, or designated investment alternative, even if originally selected using non-pecuniary factors in a manner prohibited by the final rule; however, after the effective date, all decisions regarding such investments, investment courses of action, or designated investment alternatives, including decisions that are part of a fiduciary's ongoing monitoring requirements, must comply with the final rule.<sup>56</sup> Also, although the Department believes that much of the final rule explains pre-existing duties under the statute, the Department of course will not pursue enforcement, and does not believe any private action would be viable, pertaining to any action taken or decision made with respect to an investment or investment course of action by a plan fiduciary prior to the effective date of the final rule to the extent that any such enforcement action would necessarily rely on citation to this final rule. Of course, nothing in this regulation forecloses the Department from taking enforcement action based on prior conduct that violated ERISA's provisions, including the statutory duties of prudence and loyalty, based on the statutory and regulatory standards in effect at the time of the violation.

The final rule does include one extended compliance date; new paragraph (g)(2) provides that plans shall have until April 30, 2022 to make any changes to qualified default investment alternatives described in 29 CFR 2550.404c-5, where necessary to comply with the requirements of paragraph (d)(2). Unlike other provisions of the final rule, which apply

<sup>56</sup> *Tibble v. Edison Int'l*, 135 S. Ct. 1823, 1828–29 (2015), confirmed that ERISA fiduciaries have a continuing duty—separate and apart from the duty to exercise prudence in selecting investments at the outset—to monitor, and remove imprudent, trust investments. How that monitoring obligation would be applied in the context of the final rule's application to individual investments would depend on the facts and circumstances. When and what kind of review would depend on the facts and circumstances. ERISA fiduciaries must discharge their fiduciary responsibilities “with the care, skill, prudence, and diligence” that a prudent person “acting in a like capacity and familiar with such matters” would use. ERISA section 404(a)(1). The Department notes that it may be that a fiduciary could prudently determine that the expected return balanced against the costs and risks of loss associated with divesting an investment made before the effective date of the rule are such that continuing to hold that investment would be appropriate even if the fiduciary as part of its monitoring process determined that the investment, or aspects of the decision-making process, does not comply with the final rule.

only to prospective investment decisions, paragraph (d)(2) prohibits certain designated investment alternatives from being used as a QDIA where the investment objectives or goals or the principal investment strategies include, consider, or indicate the use of one or more non-pecuniary factors. Although the Department believes the paragraph (d)(2), as modified from the proposal, will only affect a very small number of plans,<sup>57</sup> the Department recognizes that those plans will need appropriate time to modify their QDIA selections. Therefore, in response to a commenter's requests for at least a 12 month transition period, the Department is providing a QDIA compliance date of April 30, 2022.

Moreover, EBSA confirms that until January 12, 2021, the prior 404a-1 regulation under the Act (as it appeared in the July 1, 2020, edition of 29 CFR part 2550) applies.

The final rule also includes, in paragraph (h), a severability provision, which provides that if any provision in the final rule is found to be invalid or unenforceable by its terms, or as applied to any person or circumstance, or stayed pending further agency action, such provision shall be severable and the remaining portions of the rule would remain operative and available to plan administrators. Thus, if a Federal court were to find a specific provision to be legally insufficient, then the remaining requirements would remain applicable and in place.

### 8. Miscellaneous Issues and Public Comments

#### a. Religious Freedom Restoration Act

One commenter argued that the proposal violates the Religious Freedom Restoration Act (RFRA). The commenter averred that the proposal is a burden on religion and is contrary to RFRA because, in the commenter's view, it prohibits the inclusion of investment options in defined contribution plans for retirement savers whose beliefs and values dictate that they take material environmental and societal effects of corporate activities into consideration in stewardship of their worldly riches. As a result, many people of faith would be forced to support economic activity that violates their beliefs. By singling out ESG investment options as raising “heightened concerns under ERISA” whenever an option ambiguously might involve “one or more environmental, social, and corporate governance-oriented assessments or judgments,”

<sup>57</sup> In the Regulatory Impact Analysis, the Department estimates that only 0.1 percent of plans may have an affected QDIA.

despite the availability of numerous prudently managed and outperforming ESG investment options for ERISA pension plans, the proposal would have the practical effect of unnecessarily limiting access by people of faith to prudent pension investment options aligned with their religious beliefs, according to this commenter. The commenter asserted that RFRA provides an exception only if two conditions are met, that the restriction must be in furtherance of a compelling government interest and the rule must be the least restrictive way in which the government can further its interest, and the proposal does not meet those conditions. Other commenters also suggested that the proposal's interference with the investment preferences of retirement investors potentially would constitute a violation of their First Amendment rights, though they did not explain whether they were referring to the Free Exercise Clause or the Free Speech Clause.

A commenter also explained that some funds, not marketed as ESG funds, exclude “sin” stocks, such as alcohol and tobacco. Typically, these restrictions are not part of the investment objectives or strategy and do not impact the fund's ability to find suitable investments, according to the commenter. The commenter suggested that the proposed rule's broad definition of ESG would sweep in many such funds and subject them to heightened fiduciary scrutiny. According to the commenter, such restrictions, dating back to the 1950s, qualitatively differ from those embraced by the emerging universe of ESG funds. Faith-based organizations operating under Title I (e.g., ERISA-electing church plans) use such funds and use faith-based filters to eliminate certain categories. According to the commenter, these are founded on the concern of discouraging plan participation if the only investment options available to participants with strong religious convictions permitted investments relating to alcohol or tobacco. These restrictions may also fairly be viewed by some as relevant to an analysis about the likely long-term value of an issuer deriving the majority of revenue from products whose continued use could be impacted by societal changes, according to this commenter.

The Department is committed to fulfilling its obligations under RFRA and respecting religious liberty. The Department is confident that the RFRA concerns raised by the commenter can be reviewed and resolved as needed on an individual basis. While broader discussion and resolution of RFRA-

related issues can be appropriate in rulemaking, especially when they are a prominent aspect of the rulemaking, *see Little Sisters of the Poor Saints Peter & Paul Home v. Pennsylvania*, 140 S. Ct. 2367, 2383–84 (2020), the Department believes that it need not conduct a broadly applicable RFRA analysis in this particular rule, which does not have religious concerns as a central focus. If RFRA's interaction with this final rule reveals over time that a broader project is warranted, the Department will consider doing so.

Moreover, the Department believes that changes made in the final rule, including significant changes to specific conditions related to use of ESG considerations, may provide enough flexibility to sufficiently address the commenters' concerns, even without invocation of RFRA. Further, paragraph (d)(2) of the final rule permits a prudently selected ESG-themed investment alternative, which complies with paragraphs (a) and (c) of the final rule, to be added to the available investment options on a participant-directed individual account plan platform without requiring the plan to forego adding other non-ESG-themed investment options to the platform. Paragraph (d)(2) applies equally to an investment fund, product, or model portfolio that promotes, seeks, or supports participant preferences regarding religion. In addition, paragraph (d)(2)(ii) of the final rule does not prevent a negatively screened fund from being selected as a QDIA if no non-pecuniary factors are reflected in its investment objectives or principal strategies.

#### b. Coordination With Other Federal Laws and Policies

A number of commenters suggested that the Department's action is untimely, and might redirect or stall the continuing development of ESG practice at a time when the SEC continues to monitor and evaluate ESG developments, with a clear focus on disclosure and accuracy. For example, several commenters noted that the proposal appeared to reflect concerns with the marketing of investment strategies that use ESG criteria. These concerns, commenters suggested, may be addressed by the SEC, which recently solicited public comment on a number of issues (including use of the term "ESG" in a fund name) under the "Names Rule" under the Investment Company Act of 1940.<sup>58</sup> Other commenters believed that the proposal's characterization of the materiality of

ESG criteria was potentially out of step with the SEC, which has noted the importance of disclosing ESG factors to the extent that they are material. A commenter indicated that risk disclosure is fundamental to protecting investors. The commenter criticized the proposal for cautioning fiduciaries to scrutinize fund risk disclosures when evaluating the impact of ESG considerations, and suggested that any additional risk added by ESG considerations is unacceptable regardless of the reason for the risk or the effect on returns. The commenter explained that ESG considerations are used in a variety of ways in fund portfolios—some pecuniary in nature and others solely as an incidental component of the fund's investment strategy. Further, the comment indicated that when funds take ESG considerations into account, they are pursuing an investment strategy. Each strategy is different, and will perform differently with different risks. In the commenter's opinion, if the ESG consideration is used to enhance the overall value of the investment, and the risk and return are appropriately balanced, then the fact that the risks are "different" should not be the focus of the analysis. The commenter concluded that the Department's focus instead should be on risk disclosures that suggest the fund is sacrificing investment returns or assuming greater investment risk as a means to promote collateral social policy goals.

Another commenter indicated that some ESG issues pose systemic risks to financial markets, which the US financial regulatory community is beginning to examine. A commenter also suggested that the proposal might have the unintended consequence of concentrating investment in securities and products that may or may not bear less risk and greater return in the future, relying on mechanical use of financial data from one reporting source rather than employing human judgment and prudence. The commenter cautioned that this concentration will pose systemic financial risk and is something the Office of Financial Research (OFR) is tracking and seeking to minimize. The commenter suggested that the OFR should be consulted on any sweeping new ERISA rule that might cause herding and market concentration.

With respect to the Names Rule, the Department does not believe there is a need to delay a final rule until the SEC decides whether to take action as a result of its solicitation. Although disclosures may be helpful to fiduciaries in evaluating investment funds, the primary goal of the proposed and final

rule is to provide, in the form of a final rule, guidance on the scope of fiduciary duties surrounding non-pecuniary issues. However, the Department will continue to monitor SEC activity, and consider providing further guidance as may be appropriate. With respect to the other comments, the Department believes that changes made in the final rule, including a focus on pecuniary factors rather than ESG factors, are sufficient to address the stated concerns. As to the comments regarding ESG disclosure, the Department has clarified that they apply to circumstances where prospectuses or marketing materials discuss non-pecuniary objectives or benefits. We note that the Department's concerns under ERISA, and the policies underlying this final rule, are focused on safeguarding the interests of participants and beneficiaries in their plan benefits. If financial regulators adopt new rules or policies that affect financial market participants, that may create pecuniary or non-pecuniary considerations for plan fiduciaries apart from ERISA.

Commenters noted that the Department of State, Department of the Treasury, Department of Commerce, and Department of Homeland Security have taken positions on risks of supply chain links to entities that engage in human rights abuses, including forced labor, in China. They argued that the Department should not issue a rule that fundamentally undermines policy from four other Departments and should ensure that pension fiduciaries are not discouraged from making the appropriate calculations about supply chain risks. Further, commenters criticized that the proposal conflicts with the Department's own statements regarding the need to divest the Federal Thrift Savings Plan (TSP) from investments in China due to increased risk. The Department believes the concerns expressed by these commenters are beyond the scope of issues being addressed by the final rule, which is limited to the investment duties of fiduciaries under Title I of ERISA. Nonetheless, if a fiduciary prudently determines that an investment is appropriate based solely on pecuniary considerations, including those that may derive from ESG factors, the fiduciary may make the investment without regard to any collateral benefits. Accordingly, the Department does not agree that there is any fundamental conflict between the positions other agencies have articulated on supply chain risk, and this final rule. Nothing in the final rule is intended to or does prevent a fiduciary from appropriately

<sup>58</sup> 85 FR 13221 (Mar. 6, 2020).

considering any material risk with respect to an investment. Moreover, with respect to the TSP, which is not covered by Title I of ERISA, we note that the Department's position with respect to investments in China was informed by consideration of specific matters relating to investment risk, including inadequate investor disclosures and legal protections, that are consistent with "pecuniary factors" as used in the final rule. We note that matters relating to investments in China continue to be examined by other Federal agencies.<sup>59</sup> Moreover, other concerns were raised because the Federal Government matches TSP contributions and investments in China might result in the Federal Government funding activities that are opposed to U.S. national security interests.

One commenter claimed that the DOL's failure to consult with the Fish and Wildlife Service and the National Marine Fisheries Service regarding the proposed rule's impacts upon endangered species violates the Endangered Species Act (ESA), and the DOL's failure to assess the proposed rule's environmental impacts violates the National Environmental Policy Act (NEPA). The Department has reviewed the relevant legal provisions of the ESA and NEPA and concludes neither statute is implicated by the rule. In addition, the final rule's operative language does not expressly address ESG investments, but rather centers on the fiduciary duty to focus plan investment decisions on pecuniary factors only, a duty arising from ERISA and confirmed in the case law. The Department believes this change further renders the final rule beyond the scope of either ESA or NEPA, and any accompanying consultation or assessment requirements.

#### c. Comparison of Proposal to International Standards and Practices

Commenters also asserted that the Department's proposal is against an international trend in the consideration of ESG factors. Other regulators, they argued, are requiring consideration of financially material ESG factors and focusing on the importance of the disclosure of those factors. European regulators have imposed rules, effective March 10, 2021, that require investment managers governed by the regulations to incorporate financially material ESG factors into the investment process. Another commenter contended that

across the world's 50 largest economies, there have been more than 730 hard and soft law policy revisions across some 500 policy instruments, which support, encourage, or require investors to consider long-term value drivers, including ESG factors. To the extent that these foreign standards condone sacrificing returns to consider non-pecuniary objectives, they are inconsistent with the fiduciary obligations imposed by ERISA. According to this commenter, of these top 50 economies, 48 have some form of policy designed to help investors consider sustainability risks, opportunities, or outcomes. The Department believes that assertions by these commenters do not fairly characterize the statements the Department made in the proposal. The final rule does not preclude consideration of any factor that is financially material to an investment or investment course of action. In addition, a few comments cited statements supporting non-financial investment considerations, thereby confirming the need for the Department to clarify ERISA fiduciary duties in the face of investment practices that stray from pecuniary considerations. Moreover, the final rule reflects ERISA's requirements, and commenters acknowledged that the duties of prudence and loyalty under ERISA may not be the same investment standards under which international regulation is taking place. Accordingly, international trends in the consideration of ESG factors or the actions of regulators in other countries are not an appropriate gauge for evaluating ERISA's requirements as they apply to investments of ERISA-covered employee benefit plans.

#### d. Proxy Voting

Commenters expressed concern that the proposal does not directly mention proxy voting or corporate stewardship and argue that any treatment of ESG investment practices should include those topics. Those issues technically are outside of the scope of this rulemaking. On September 4, 2020, the Department published a proposed amendment to the investment duties regulation to address the application of the prudence and exclusive purpose duties to the exercise of shareholder rights, including proxy voting, the use of written proxy voting policies and guidelines, and the selection and monitoring of proxy advisory firms.<sup>60</sup>

#### e. ESG Rating Systems and ESG Indices

Some commenters were concerned that the Department's expressed skepticism about ESG rating systems and its assertion that "[t]here is no consensus about what constitutes a genuine ESG investment, and ESG rating systems are often vague and inconsistent," is unfair. They also challenged the Department's observation that "fiduciaries should also be skeptical of 'ESG rating systems'—or any other rating system that seeks to measure, in whole or in part, the potential of an investment to achieve non-pecuniary goals—as a tool to select designated investment alternatives, or investments more generally." Such cautions, the commenters assert, cast a pall on the use of ESG ratings and substitute the judgment of the Department for that of plan fiduciaries who may find one or more of these ratings an appropriate investment tool. However, one commenter submitted materials describing sustainability ratings as "black boxes" in which ratings providers publish only a general description of their approaches; to the extent that any more detailed information is available, it is provided only to subscribers.

Another commenter stated that manufacturing companies often face calls from third-party actors (who do not have a stake in the business or any interest in shareholders' long-term returns) to address ESG issues in a one-size-fits-all way that meets only the political needs of outside activists. In recent years, the commenter argued, this pressure has been driven in large part by ESG ratings firms that have a financial interest in ensuring more widespread adoption of non-pecuniary ESG investing criteria. The commenter complained that these firms operate by boiling down a complex issue (or, often, multiple complex issues) into a single numerical score or letter grade with little to no disclosure as to how such score or grade is calculated, nor its impact on shareholder value creation. These one-size-fits-all standards do not take into account the individual circumstances of a given company or provide any context for a company's ESG work outside of the check-the-box approach favored by the ratings firms. Furthermore, the commenter avers, it is often unclear to issuers and investors alike exactly what data went into calculating a given rating. This commenter stated that pension plan managers making investment decisions based on these ratings are staking plan participants' retirement savings on the opinions of unregulated, nontransparent

<sup>59</sup> See, e.g., Statement on SEC Response to the Report of the President's Working Group on Financial Markets (Aug. 10, 2020), [www.sec.gov/news/public-statement/statement-presidents-working-group-financial-markets](http://www.sec.gov/news/public-statement/statement-presidents-working-group-financial-markets).

<sup>60</sup> 85 FR 55219 (Sept. 4, 2020).

entities that have no obligation to make decisions in pensioners' best interests. The commenter has called for the Securities and Exchange Commission to provide effective oversight of ESG raters and strongly supports the DOL's guidance that ERISA fiduciaries should be "skeptical" of ESG ratings systems. Similarly, the commenter appreciated that the proposed rule highlights the fact that ESG ratings firms "typically emphasize tick-the-box policies and disclosure levels, data points unrelated to investment performance, and/or backward-looking negative events with little predictive power."

In footnote 24 of the proposal, the Department stated that fiduciaries should be skeptical of ESG rating systems—or any other rating system that seeks to measure, in whole or in part, the potential of an investment to achieve non-pecuniary goals—as a tool to select designated investment alternatives, or investments more generally. The Department has not changed its views as to the need for fiduciaries to carefully examine ESG rating systems before relying on them to make investment decisions. The Department notes that an ERISA plan fiduciary should evaluate any rating system with care, skill, prudence, and diligence in order to determine that the rating system appropriately considers only pecuniary factors if such rating system is used to evaluate an investment.

Skepticism of ESG or sustainability rating systems is warranted under ERISA because such ratings systems may involve the evaluation of non-pecuniary factors. While individual 'E', 'S', or 'G' factors evaluated by a ratings provider may be a pecuniary factor for a particular investment or investment course of action it does not follow that all factors under the ESG rubric are pecuniary for all investments. And because ESG factors are so disparate—and often idiosyncratic—a fiduciary may not assume that combining them into a single rating, index, or score creates an amalgamated factor that is itself pecuniary. If ESG or sustainability rating systems are to be used, a fiduciary should conduct appropriate due diligence to understand how the ratings are determined, for example methodology, weighting, data sources, and the underlying assumptions used by such rating systems. Similarly, in selecting an investment fund that follows an ESG index, a fiduciary should also conduct appropriate due diligence and understand the ESG index objective, how the ESG index is constructed and maintained, its performance benchmarks, and how the

factors and weightings used by the ESG index are pecuniary. For example, should specific ESG factors become reliably and consistently identified, and widely recognized by qualified investment managers as pecuniary factors that are predictive of financial performance, then nothing in the final rule would prohibit their use by plan fiduciaries.

f. Interpretive Bulletin 2015–1 (IB 2015–1) and Field Assistance Bulletin 2018–01 (FAB 2018–01)

The final rule also withdraws IB 2015–1 and removes it from the Code of Federal Regulations. Accordingly, as of publication of this final rule, IB 2015–1 may no longer be relied upon as reflecting the Department's interpretation of the application of ERISA's fiduciary responsibility provisions to the selection of investments and investment courses of action.

Similarly, FAB 2018–01, which concerned both "ESG Investment Considerations" and "Shareholder Engagement Activities," is superseded in part. Accordingly, as of publication of this final rule, the portion of FAB 2018–01 under the heading "ESG Investment Considerations" will be null and void and will be disregarded by the Department.

### E. Regulatory Impact Analysis

This section analyzes the regulatory impact of a final regulation concerning the legal standard imposed by sections 404(a)(1)(A) and 404(a)(1)(B) of ERISA with respect to investment decisions involving plan assets. In particular, it addresses the selection of a plan investment or, in the case of an ERISA section 404(c) plan or other individual account plan, a designated investment alternative under the plan. This final rule addresses the limitations that section 404(a)(1)(A) and 404(a)(1)(B) of ERISA impose on fiduciaries' consideration of non-pecuniary benefits and goals when making investment decisions, including environmental, social, and corporate governance and other similar factors.

Thus, the rule sets forth standards of prudence and loyalty for selecting and monitoring investments. This rule imposes some costs. For example, some plans will incur costs to review the rule to ensure compliance, document the basis for certain investment decisions, and ensure their QDIA does not contain prohibited characteristics. The research and analysis used to select investments may change, but such a change is unlikely to increase the overall cost. The transfer impacts, benefits, and costs

associated with the final rule depend on the number of plan fiduciaries that are currently not following or are misinterpreting the Department's existing sub-regulatory guidance. While the Department does not have sufficient data to estimate the number of such fiduciaries, the Department's educated estimate is small, because most fiduciaries are operating in compliance with the Department's sub-regulatory guidance. The Department acknowledges, however, that some plan fiduciaries may be making investment decisions that do not comply with the requirements of this final rule. Nevertheless, the Department expects that the gains to investors will justify the costs for participants and beneficiaries covered by plans with noncompliant investment fiduciaries. If the Department's educated estimate regarding the number of noncompliant fiduciaries is understated, the final rule's transfer impacts, and costs will be proportionately higher. Even in this instance, however, the Department believes that the rule's benefits and gains to retirement investors justify its costs.

The Department has examined the effects of this rule as required by Executive Order 12866,<sup>61</sup> Executive Order 13563,<sup>62</sup> the Congressional Review Act,<sup>63</sup> Executive Order 13771,<sup>64</sup> the Paperwork Reduction Act of 1995,<sup>65</sup> the Regulatory Flexibility Act,<sup>66</sup> section 202 of the Unfunded Mandates Reform Act of 1995,<sup>67</sup> and Executive Order 13132.<sup>68</sup>

#### 1. Executive Orders 12866 and 13563

Executive Orders 12866 and 13563 direct agencies to assess all costs and benefits of available regulatory alternatives and, if regulation is necessary, to select regulatory approaches that maximize net benefits (including potential economic, environmental, public health and safety effects; distributive impacts; and equity). Executive Order 13563 emphasizes the importance of quantifying costs and benefits, reducing costs, harmonizing rules, and promoting flexibility.

Under Executive Order 12866, "significant" regulatory actions are

<sup>61</sup> Regulatory Planning and Review, 58 FR 51735 (Oct. 4, 1993).

<sup>62</sup> Improving Regulation and Regulatory Review, 76 FR 3821 (Jan. 18, 2011).

<sup>63</sup> 5 U.S.C. 804(2) (1996).

<sup>64</sup> Reducing Regulation and Controlling Regulatory Costs, 82 FR 9339 (Jan. 30, 2017).

<sup>65</sup> 44 U.S.C. 3506(c)(2)(A) (1995).

<sup>66</sup> 5 U.S.C. 601 *et seq.* (1980).

<sup>67</sup> 2 U.S.C. 1501 *et seq.* (1995).

<sup>68</sup> Federalism, 64 FR 153 (Aug. 4, 1999).

subject to review by the Office of Management and Budget (OMB). Section 3(f) of the Executive Order defines a “significant regulatory action” as an action that is likely to result in a rule (1) having an annual effect on the economy of \$100 million or more, or adversely and materially affecting a sector of the economy, productivity, competition, jobs, the environment, public health or safety, or state, local, or tribal governments or communities (also referred to as “economically significant”); (2) creating a serious inconsistency or otherwise interfering with an action taken or planned by another agency; (3) materially altering the budgetary impacts of entitlement grants, user fees, or loan programs or the rights and obligations of recipients thereof; or (4) raising novel legal or policy issues arising out of legal mandates, the President’s priorities, or the principles set forth in the Executive Order. It has been determined that this rule is economically significant within the meaning of section 3(f)(1) of the Executive Order. Therefore, the Department has provided an assessment of the final rule’s potential costs, benefits, and transfers, and OMB has reviewed this final rule pursuant to the Executive Order. Pursuant to the Congressional Review Act, OMB has designated this final rule as a “major rule,” as defined by 5 U.S.C. 804(2), because it would be likely to result in an annual effect on the economy of \$100 million or more.

### 1.1. Introduction and Need for Regulation

Recently, there has been an increased emphasis in the marketplace on investments and investment courses of action that further non-pecuniary objectives, particularly what have been termed environmental, social, and corporate governance (ESG) investing.<sup>69</sup> The Department is concerned that the growing emphasis on ESG investing, and other non-pecuniary factors, may be prompting ERISA plan fiduciaries to make investment decisions for purposes distinct from their responsibility to provide benefits to participants and beneficiaries and defray reasonable plan administration expenses. The Department is also concerned that some investment products may be marketed to ERISA fiduciaries on the basis of purported benefits and goals unrelated to financial performance.

<sup>69</sup> See Jon Hale, *Sustainable Funds U.S. Landscape Report: Record Flows and Strong Fund Performance in 2019* (Feb. 14, 2020), [www.morningstar.com/lp/sustainable-funds-landscape-report](http://www.morningstar.com/lp/sustainable-funds-landscape-report).

The Department has periodically considered the application of ERISA’s fiduciary rules to plan investment decisions that are based, in whole or part, on non-pecuniary factors, and not simply investment risks and expected returns. The Department has made various statements on the subject over the years in sub-regulatory guidance not issued pursuant to the Administrative Procedure Act. Accordingly, this final rule is necessary to interpret ERISA regarding the scope of fiduciary duties surrounding non-pecuniary issues.

Some commenters asserted that ERISA’s prudence and loyalty duties do not justify the need for the final rule. The Department disagrees and firmly believes that fiduciaries must evaluate plan investments based solely on pecuniary factors and not subordinate the interests of the participants and beneficiaries in their retirement income or financial benefits under the plan to unrelated objectives or sacrifice investment return or take on additional investment risk to promote goals unrelated to the financial interests of the plan’s participants and beneficiaries or the purposes of the plan. The Department believes that providing a final regulation will help safeguard the interests of participants and beneficiaries in their plan benefits.

### 1.2. Affected Entities

The final rule will affect certain ERISA-covered plans whose fiduciaries consider or will begin considering non-pecuniary factors when selecting investments and the participants in those plans. Indeed, the Department received multiple comments from entities who described their use of non-pecuniary factors when selecting investments and their intention to continue using them in the future. The best data available on the topic of non-pecuniary investing comes from surveys of ESG investing by plans, thus the data used in this analysis is on ESG investing. A challenge in relying on survey data, however, is that one cannot tell how much of the ESG investing described is pecuniary or non-pecuniary.<sup>70</sup> Further complicating matters is that in selecting investments, some plans may use non-pecuniary factors that are not ESG factors, or are not perceived to be ESG factors. If survey respondents do not view them as

<sup>70</sup> See Schanzenbach & Sitkoff, *supra* note 5, at 389–90 (distinguishing between “collateral benefits ESG” investing—defined as “ESG investing for moral or ethical reasons or to benefit a third party”—which is not permissible under ERISA, and “risk-return ESG” investing, which is).

ESG factors, these plans would not be identified by surveys.

The final rule requires plan fiduciaries to meet a documentation requirement when they are unable to distinguish among alternative investments based on pecuniary factors alone and base their investment decision on non-pecuniary factors. In such circumstances, the fiduciary must document (i) why pecuniary factors were not sufficient to select the investment or investment course of action; (ii) how the investment compares to the alternative investments with regard to the certain factors, and (iii) how the non-pecuniary chosen factor is, or factors are, consistent with interests of the participants and beneficiaries in their retirement income or financial benefits under the plan. According to a 2018 survey by the NEPC, approximately 12 percent of private pension plans have adopted ESG investing.<sup>71</sup> Another survey, conducted by the Callan Institute in 2019, found that about 19 percent of private sector pension plans consider ESG factors in investment decisions.<sup>72</sup> Both of these estimates are calculated from samples that include both defined benefit (DB) and defined contribution (DC) plans. Some DB plans that consider ESG factors will not be affected by the final rule because they focus only on the financial aspects of ESG factors, rather than on non-pecuniary objectives. In order to generate an upper-bound estimate of the costs, however, the Department assumes that 19 percent of DB plans will be affected by the final rule. This represents approximately 8,905 DB plans.<sup>73</sup> The Department also assumes that 19 percent of DC plans with investments that are not participant-directed will be affected; this represents an additional 17,676 plans.<sup>74</sup>

Participant-directed individual account DC plans and their participants will be affected by the final rule if fiduciaries respond to participant demand by examining ESG options for inclusion among their plans’ designated investment alternatives. Fiduciaries of

<sup>71</sup> Brad Smith & Kelly Regan, *NEPC ESG Survey: A Profile of Corporate & Healthcare Plan Decisionmakers’ Perspectives*, NEPC (Jul. 11, 2018), <https://cdn2.hubspot.net/hubfs/2529352/files/2018%2007%20NEPC%20ESG%20Survey%20Results%20.pdf?t=1532123276859>.

<sup>72</sup> 2019 ESG Survey, Callan Institute (2019), [www.callan.com/wp-content/uploads/2019/09/2019-ESG-Survey.pdf](http://www.callan.com/wp-content/uploads/2019/09/2019-ESG-Survey.pdf).

<sup>73</sup> DOL calculations are based on statistics from *Private Pension Plan Bulletin: Abstract of 2018 Form 5500 Annual Reports*, Employee Benefits Security Administration (forthcoming 2020), (46,869 \* 19% = 8,905 DB plans).

<sup>74</sup> Id. (93,033 \* 19% = 17,676 plans).

such plans may also select investments using non-pecuniary factors when the fiduciary is unable to distinguish alternative investment options based on pecuniary considerations. A small share of individual account plans offer at least one ESG-themed option among their designated investment alternatives. According to the Plan Sponsor Council of America, about three percent of 401(k) and/or profit sharing plans offered at least one ESG-themed investment option in 2018.<sup>75</sup> Vanguard's 2018 administrative data show that approximately nine percent of DC plans offered one or more "socially responsible" domestic equity fund options.<sup>76</sup> In a comment letter, Fidelity Investments reported that 14.5 percent of corporate DC plans with fewer than 50 participants offered an ESG option, and that the figure is higher for large plans with at least 1,000 participants. Considering these sources together, the Department estimates that nine percent of participant-directed individual account plans have at least one ESG-themed designated investment alternative and will be affected by the final rule. This represents 52,378 participant-directed individual account plans.<sup>77</sup> In terms of the actual investment in ESG options, one survey indicates that about 0.1 percent of total DC plan assets are invested in ESG funds.<sup>78</sup>

The rule prevents any investment fund, product, or model portfolio from being added as, or as a component of, a Qualified Default Investment Alternative (QDIA) if its investment objectives or goals or its principal investment strategies include, consider, or indicate the use of one or more non-pecuniary factors. To assess the impact of this provision, it is important to determine how many DC plans have a QDIA. According to a 2018 survey conducted by the Plan Sponsor Council of America, about 70 percent of DC plans have a QDIA.<sup>79</sup> This represents approximately 407,382 individual account plans with participant

direction.<sup>80</sup> As specified in 29 CFR 2550.404c-5, there are four permitted types of QDIAs: Target-date funds, professionally managed accounts, balanced funds, and capital preservation products for only the first 120 days of participation. The 2018 survey from Plan Sponsor Council of America also found that approximately 75 percent of QDIAs are target-date funds, while 12 percent are balanced funds, 7 percent are professionally managed accounts, 4 percent are stable value funds, and the remaining 2 percent are investments classified as "other."<sup>81</sup>

To better understand how many plans with QDIAs would be affected by the rule, the Department looked at the holdings of target-date fund providers. According to Morningstar, the five largest target-date fund providers account for 79 percent of target-date strategy assets.<sup>82</sup> The Department examined the most recent holdings, as of September 2020, of the target-date funds offered by the five largest target-date fund providers, denoting target-date funds that either had an investment strategy considering non-pecuniary factors or that were invested in a fund with a non-pecuniary investment focus. Within this sample, the Department found only one target-date fund provider that had issued a target-date series with an ESG focus. This series was launched in 2020, and as of September 2020, this series accounted for less than 0.002 percent of assets in the sample. The Department also examined other target-date funds it was aware of that had an ESG focus. When looking at the total net asset value for each of the target date series from Morningstar Direct, the Department found that target-date funds with an ESG focus account for a very small portion of the assets invested in the target-date market. When looking at preliminary data from BrightScope on the holdings of 401(k) and 403(b) plans for 2018, the Department found that target-date funds with an ESG focus account for an even smaller portion of the target-date assets in ERISA plans.

For the purpose of this analysis, the Department assumes that the

characteristics of the five largest providers of target-date funds are representative of the investment alternatives offered as QDIAs. As the target-date series noted above is relatively new, and the Department is aware of at least one other target-date series focusing on non-pecuniary factors, the Department assumes that 0.1 percent of plans will need to make changes to their QDIAs. Based on the foregoing, the Department assumes that 407 plans with QDIAs will be affected by the rule.<sup>83</sup>

### 1.3. Gains to Retirement Investors

The final rule will replace existing guidance on the use of ESG and similar factors in the selection of investments. It will lead to less use of non-pecuniary factors in selecting DB plan investments and participant-directed individual account plan QDIAs. These effects may provide gains to retirement investors in the form of higher returns by preventing fiduciaries from selecting investments by factoring in non-pecuniary ESG considerations and requiring them to base investment decisions on financial factors.

The final rule states that fiduciaries for DB plans must base investment decisions on pecuniary factors unless the plan fiduciary is unable to distinguish alternative investment options on the basis of pecuniary factors and such a conclusion is properly documented. This will lead to a decrease in the use of non-pecuniary factors in selecting DB plan investments. Defined contribution plans that do not have participant direction will be similarly affected with the same results.

This rule specifically addresses circumstances when participant-directed individual account plan fiduciaries select designated investment alternatives. Such fiduciaries are not automatically prohibited from casting a broad net to consider or include an investment fund, product, or model portfolio merely because the fund, product, or model portfolio promotes, seeks, or supports one or more non-pecuniary goals, so long as fiduciaries meet the final rule's requirement to base final selection decisions on pecuniary factors. If the pecuniary factors lead to situations where plan fiduciaries are unable to distinguish alternative investment options on the basis of pecuniary factors, the plan fiduciary can make a selection based on non-pecuniary factors if they properly document the basis for their decision. It is unclear whether fiduciaries will

<sup>75</sup> 62nd Annual Survey of Profit Sharing and 401(k) Plans, Plan Sponsor Council of America (2019).

<sup>76</sup> How America Saves 2019, Vanguard (June 2019), <https://institutional.vanguard.com/iam/pdf/HAS2019.pdf>.

<sup>77</sup> DOL calculations based on statistics from Private Pension Plan Bulletin: Abstract of 2018 Form 5500 Annual Reports, Employee Benefits Security Administration (forthcoming 2020), (581,974 \* 9% = 52,378 individual account plans with participant direction).

<sup>78</sup> 62nd Annual Survey of Profit Sharing and 401(k) Plans, Plan Sponsor Council of America (2019).

<sup>79</sup> Id.

<sup>80</sup> DOL calculations based on statistics from Private Pension Plan Bulletin: Abstract of 2018 Form 5500 Annual Reports, Employee Benefits Security Administration (forthcoming 2020), (581,974 \* 70% = 407,382 individual account plans with participant direction).

<sup>81</sup> 62nd Annual Survey of Profit Sharing and 401(k) Plans, Plan Sponsor Council of America (2019).

<sup>82</sup> Morningstar, 2020 Target-Date Strategy Landscape, How Target-Date Shareholders Fared in the Coronavirus Bear Market and the Trends Shaping the Future of Investing for Retirement (2020).

<sup>83</sup> 407,383 \* 0.001 = 407.



increase selection of non-pecuniary funds as designated investment alternatives, and consequently, how returns may be affected.

Furthermore, the rule prohibits plan fiduciaries from adding any investment fund, product, or model portfolio as, or as a component of, a QDIA if its investment objectives or goals or its principal investment strategies include, consider, or indicate the use of one or more non-pecuniary factors. The Department expects that requiring a fiduciary's selection of a QDIA to be based solely on pecuniary factors will lead to higher returns for the reasons discussed above.

Some commenters objected to the Department's characterization in the proposal of the empirical research assessing ESG investing. Indeed, the research studies have a wide range of findings. Some studies have shown that ESG investing outperforms conventional investing. Verheyden, Eccles, and Feiner's research analyzes stock portfolios that used negative screening<sup>84</sup> to exclude operating companies with poor ESG records from the portfolios.<sup>85</sup> The study finds that negative screening tends to increase a stock portfolio's annual performance by 0.16 percent. Similarly, Kempf and Osthoff's research, which examines stocks in the S&P 500 and the Domini 400 Social Index (renamed as the MSCI KLD 400 Social Index in 2010), finds that it is financially beneficial for investors to positively screen their portfolios.<sup>86</sup> Additionally, Ito, Managi, and Matsuda's research finds that socially responsible funds outperformed conventional funds in the European Union and United States.<sup>87</sup>

In contrast, other studies have found that ESG investing has resulted in lower returns than conventional investing. For example, Winegarden shows that over ten years, a portfolio of ESG funds has a return that is 43.9 percent lower than if it had been invested in an S&P 500 index fund.<sup>88</sup> Trinks and Scholten's

research, which examines socially responsible investment funds, finds that a screened market portfolio significantly underperforms an unscreened market portfolio.<sup>89</sup> Ferruz, Muñoz, and Vicente's research, which examines U.S. mutual funds, finds that a portfolio of mutual funds that implements negative screening underperforms a portfolio of conventionally matched pairs.<sup>90</sup> Likewise, Ciciretti, Dalò, and Dam's research, which analyzes a global sample of operating companies, finds that companies that score poorly in terms of ESG indicators have higher expected returns.<sup>91</sup> Marsat and Williams' research has very similar findings.<sup>92</sup> Operating companies with better ESG scores according to MSCI had lower market valuation.

Furthermore, there are many studies with inconclusive results. Goldreyer and Diltz's research, which examines 49 socially responsible mutual funds, finds that employing positive social screens does not affect the investment performance of mutual funds.<sup>93</sup> Similarly, Renneboog, Ter Horst, and Zhang's research, which analyzes global socially responsible mutual funds, finds that the risk-adjusted returns of socially responsible mutual funds are not statistically different from conventional funds.<sup>94</sup> Bello's research, which examines 126 mutual funds, finds that the long-run investment performance is not statistically different between conventional and socially responsible funds.<sup>95</sup> Likewise, Ferruz, Muñoz, and Vicente's research finds that a portfolio of mutual funds that implement positive screening<sup>96</sup> performs equally well as a portfolio of conventionally matched-

pairs.<sup>97</sup> Finally, Humphrey and Tan's research, which examines socially responsible investment funds, finds no evidence of negative screening affecting the risks or returns of portfolios.<sup>98</sup>

The final rule emphasizes the importance of plan fiduciaries focusing on pecuniary factors when selecting investments. This emphasis may encourage fiduciaries to pay greater attention to fees. If, as a result of the final rule, assets are invested in funds with lower fees on average, the reduced fees, minus potential upfront transition costs, will represent gains to retirement investors.

To the extent that ESG and other investing decisions sacrifice return to achieve non-pecuniary goals, it reduces participant and beneficiaries' retirement investment returns, thereby compromising a central purpose of ERISA. Given the increase in ESG investing, the Department is concerned that, without this rulemaking, non-pecuniary ESG investing will present a growing threat to ERISA fiduciary standards and, ultimately, to investment returns and retirement income security for plan participants and beneficiaries. The gains to investors derived from higher investment returns compounded over many years could be considerable for plans and participants that would be impacted by plan fiduciaries' increased reliance on pecuniary factors as required by the final rule.

If some portion of the increased returns realized by the rule are associated with ESG investments generating lower pre-fee returns than non-ESG investments (as regards economic impacts that can be internalized by parties conducting market transactions), then the new returns qualify as gains to investors from the rule. It would, however, be important to track externalities, public goods, or other market failures that might lead to economic effects of the non-ESG activities being potentially less fully internalized than ESG activities' effects would, and thus generating costs to society on an ongoing basis. Finally, if some portion of the increased returns would be associated with transactions in which the opposite party experiences decreased returns of equal magnitude, then this portion of the rule's impact would, from a society-wide perspective, be appropriately categorized as a transfer (though it should be noted that, if there is evidence of wealth differing

<sup>89</sup> Pieter Jan Trinks and Bert Scholtens, *The Opportunity Cost of Negative Screening in Socially Responsible Investing*, 140 *Journal of Business Ethics* 2 (2014).

<sup>90</sup> Luis Ferruz, Fernando Muñoz, and Ruth Vicente, *Effect of Positive Screens on Financial Performance: Evidence from Ethical Mutual Fund Industry* (2012).

<sup>91</sup> Rocco Ciciretti, Ambrogio Dalò, and Lammertjan Dam, *The Contributions of Betas versus Characteristics to the ESG Premium* (2019).

<sup>92</sup> Sylvain Marsat and Benjamin Williams, *CSR and Market Valuation: International Evidence. Bankers, Markets & Investors: An Academic & Professional Review*, Groupe Banque (2013).

<sup>93</sup> Elizabeth Goldreyer and David Diltz, *The Performance of Socially Responsible Mutual Funds: Incorporating Sociopolitical Information in Portfolio Selection*, 25 *Managerial Finance* 1 (1999).

<sup>94</sup> Luc Renneboog, Jenke Ter Horst, and Chendi Zhang, *The Price of Ethics and Stakeholder Governance: The Performance of Socially Responsible Mutual Funds*, 14 *Journal of Corporate Finance* 3 (2008).

<sup>95</sup> Zakri Bello, *Socially responsible investing and portfolio diversification*, 28 *Journal of Financial Research* 1 (2005).

<sup>96</sup> Positive screening refers to including certain sectors and companies that meets the criteria of non-financial objectives.

<sup>97</sup> Ferruz, Muñoz, and Vicente, *Effect of Positive Screens on Financial Performance* (2012).

<sup>98</sup> Jacquelyn Humphrey and David Tan, *Does It Really Hurt to be Responsible?*, 122 *Journal of Business Ethics* 3 (2014).

<sup>84</sup> Negative screening refers to the exclusion of certain sectors, companies, or practices from a fund or portfolio based on ESG criteria.

<sup>85</sup> Tim Verheyden, Robert G. Eccles, and Andreas Feiner, *ESG for all? The Impact of ESG Screening on Return, Risk, and Diversification*, 28 *Journal of Applied Corporate Finance* 2 (2016).

<sup>86</sup> Alexander Kempf and Peer Osthoff, *The Effect of Socially Responsible Investing on Portfolio Performance*, 13 *European Financial Management* 5 (2007).

<sup>87</sup> Yutaka Ito, Shunsuke Managi, and Akimi Matsuda, *Performances of Socially Responsible Investment and Environmentally Friendly Funds*, 64 *Journal of the Operational Research Society* 11 (2013).

<sup>88</sup> Wayne Winegarden, *Environmental, Social, and Governance (ESG) Investing: An Evaluation of the Evidence*. Pacific Research Institute (2019).

across the transaction parties, it would have implications for marginal utility of the assets).

#### 1.4. Costs

This final rule provides guidance on the investment duties of a plan fiduciary. Under this final rule, plan fiduciaries who consider ESG and similar factors when choosing investments will be reminded that they may evaluate only the investments' relevant economic pecuniary factors to determine the risk and return profiles of the alternatives. It is the Department's view that many plan fiduciaries already undertake such evaluations, though many that consider ESG and similar factors may not be treating those as pecuniary factors within the risk-return evaluation. This final rule will not impair fiduciaries' appropriate consideration of ESG factors in circumstances where such consideration is material to the risk-return analysis and, as a result, advances participants' interests in their retirement benefits. The Department does not intend to increase fiduciaries' burden of care attendant to such consideration; therefore, no additional costs are estimated for this requirement. While fiduciaries may modify the research approach they use to select investments as a consequence of the final rule, the Department assumes this modification will not impose significant additional cost.

The Department solicited comments on its cost analysis in the regulatory impact analysis for the proposed rule. While some commenters provided insights the Department could use to improve its analysis, few commenters provided additional data or data sources to help the Department quantify the cost impacts of the rule.

Commenters suggested that the analysis did not account for the movement from ESG assets to non-ESG assets due to the rule and the related costs of this movement. Commenters provided several reasons for this movement including, the proposed rule favors non-ESG investments; additional costs are required to document decisions to invest in ESG investments in certain circumstances; and increased litigation risk. Commenters suggested that this movement from ESG to non-ESG investments would create a cost due to lost returns, suggesting that ESG investments outperform non-ESG investments.

The Department disagrees with most of these comments; changes made in the final rule strengthen the Department's view that commenters' concerns are overstated. For example, the final rule

reaffirms that plan investments and investment alternatives are to be chosen based on pecuniary factors. If an investment, including an ESG investment, is expected to outperform other similar investments, fills a plan's needs, and meets other relevant requirements under ERISA, it can be selected and the plan and plan participants will benefit from its inclusion. If an investment, including an ESG investment, is expected to underperform other similar investments, it does not satisfy the final rule's requirements and should not be selected. Plan investments or investment alternatives that previously followed this requirement will not experience a change in economic performance. If plan investments or investment alternatives were selected based on non-pecuniary factors and they are not maximizing the economic benefits of the plan, they should be replaced, which would increase the returns to the plan. Thus, the requirement to consider only pecuniary factors only serves to benefit the plan, and additional losses are less likely to be incurred as suggested by commenters.

Commenters also suggested that the requirement to document the decision when fiduciaries use non-pecuniary factors to choose between alternative investment options that cannot be distinguished based on pecuniary factors could drive up costs. Commenters said that these costs would lead plans to avoid selecting ESG assets due to the added cost, even when they are beneficial. The final rule significantly reduces the documentation requirements from the proposal. In the final rule, the Department explicitly requires plan fiduciaries to document three elements identified in the final rule only in the discrete (and likely rare) situations in which a fiduciary cannot distinguish between alternatives based on pecuniary factors. Stating precisely what is required to be documented in the final rule should help both lower compliance costs and address concerns about liability exposure, because fiduciaries will have clear expectations of what is expected. While the Department does include a requirement to document the decision, it continues to believe that a prudent process would already require plan fiduciaries to have considered responses to these questions, so the only added costs would be to document their reasoning and many plan fiduciaries already are doing this as part of a prudent selection process.

Further, commenters suggested that the requirement to document the use of non-pecuniary factors would subject

ESG factors to a different standard of analysis that would diminish a fiduciary's ability to act in the best interest of plan participants. In response to comments, the Department has removed the proposed requirement to document the selection and monitoring of designated investment alternatives that include ESG assessments. A different standard is not being created in this final rule. Fiduciaries should use a prudent process for selecting all investments. In exchange for using a non-pecuniary factor to select between or among investment alternatives that the fiduciary prudently determines would serve equivalent roles in the plan's portfolio, the rule requires fiduciaries to prepare a justification to help ensure that the decision is consistent with interests of participants and beneficiaries in their retirement income or financial benefits under the plan and not based on any other consideration.

Some commenters also expressed concern that the regulation would limit diversification and a fiduciary's ability to consider all material factors in an investment decision. The regulation specifies that compliance with section 404(a)(1)(B) of ERISA requires a fiduciary of an employee benefit plan to evaluate investments and investment courses of action based solely on pecuniary factors that have had a material effect on the return and risk. The regulation does not restrict consideration of any asset classes or sectors of investment so long as investment decisions are made solely in the interest of the plan's financial objective of providing retirement income for plan participants and beneficiaries.

Commenters suggested that the Department did not appropriately consider an investment's time horizon at all or focused only on a short-time horizon. The Department disagrees. The rule requires plan fiduciaries to "evaluate investments and investment courses of action based solely on pecuniary factors that have a material effect on the return and risk of an investment based on appropriate investment horizons." The appropriate time horizon to consider for an investment or investment alternative can be plan specific, and the rule allows the plan fiduciary to make that determination for their plan.

Some commenters expressed concern regarding how the regulation will affect the behavior of plan participants (participation rates, elective deferrals, and investment choices) and plan sponsors (offering of ESG options in plan investment menus). A change to

the final rule makes it clear that participant-directed individual account plan fiduciaries are not automatically prohibited from considering or including an investment fund, product, or model portfolio merely because the fund, product, or model portfolio promotes, seeks, or supports one or more non-pecuniary goals, provided that certain requirements are met. As discussed above, this could lead to increased participation or inflows of assets into plans.

Several of the commenters note that the rule would require plan fiduciaries to read the rule and review investment policy statements to ensure they are in compliance. The Department estimates that 78,959 plans have exposure to investments with non-pecuniary objectives, consisting of 8,905 DB plans,<sup>99</sup> 52,378 participant-directed individual account plans,<sup>100</sup> and 17,676 DC plans with ESG investments that are not participant directed.<sup>101</sup> In the proposal, the Department estimated that the incremental costs would be “minimal.” The Department agrees with commenters that fiduciaries of each of these types of plans will need to spend time reviewing the final rule, evaluating how it affects their investment practices, and implementing any necessary changes. The Department now estimates that this review process will require a lawyer to spend approximately four hours to complete, resulting in a cost burden of approximately \$44 million.<sup>102</sup>

<sup>99</sup>DOL calculations based on statistics from U.S. Department of Labor, Employee Benefits Security Administration, “Private Pension Plan Bulletin: Abstract of 2018 Form 5500 Annual Reports,” (forthcoming 2020), (46,869 DB plans \* 19% = 8,905 DB plans; 93,033 DC Plans \* 19% = 17,676 DC plans; 581,974 \* 6% = 34,918 individual account plans with participant direction).

<sup>100</sup>DOL calculations based on statistics from *Private Pension Plan Bulletin: Abstract of 2018 Form 5500 Annual Reports*, Employee Benefits Security Administration (forthcoming 2020), (581,974 \* 9% = 52,378 individual account plans with participant direction).

<sup>101</sup>DOL calculations based on statistics from U.S. Department of Labor, Employee Benefits Security Administration, “Private Pension Plan Bulletin: Abstract of 2018 Form 5500 Annual Reports,” (forthcoming 2020), (46,869 DB plans \* 19% = 8,905 DB plans; 93,033 DC Plans \* 19% = 17,676 DC plans; 581,974 \* 6% = 34,918 individual account plans with participant direction).

<sup>102</sup>The Department estimated that there are 78,959 plans that will need to ensure compliance with the final rule. The burden is estimated as follows: (78,959 plans \* 4 hours) = 315,836 hours. A labor rate of \$138.41 is used for a lawyer. The cost burden is estimated as follows: (78,959 plans \* 4 hours \* \$138.41) = \$43,714,860.76. Labor rates are based on DOL estimates from *Labor Cost Inputs Used in the Employee Benefits Security Administration, Office of Policy and Research’s Regulatory Impact Analyses and Paperwork Reduction Act Burden Calculation*, Employee Benefits Security Administration (June 2019), [www.dol.gov/sites/dolgov/files/EBSA/laws-and-regulations/rules-and-regulations/technical-appendices/labor-cost-inputs-used-in-ebsa-opr-ria-and-pra-burden-calculations-june-2019.pdf](http://www.dol.gov/sites/dolgov/files/EBSA/laws-and-regulations/rules-and-regulations/technical-appendices/labor-cost-inputs-used-in-ebsa-opr-ria-and-pra-burden-calculations-june-2019.pdf).

The Department believes that these processes will likely be performed by a service provider for most plans that likely oversee multiple plans. Therefore, the Department’s estimate likely is an upper bound, because it is based on the number of affected plans. The Department does not have data that would allow it to estimate the number of service providers acting in such a capacity for these plans.

Some fiduciaries will select investments that are different from what they would have selected pre-rule. As part of a routine evaluation of the plan’s investments or investment alternatives, fiduciaries may replace an investment or investment alternative. This could lead to some disruption, particularly for participant-directed DC plans. If a plan fiduciary removes an ESG fund as a designated investment alternative and does not replace it with a more appropriate ESG fund as a result of this final rule, participants invested in the ESG fund will have to pick a new fund that may not be comparable from their perspective. This could be disruptive.

Paragraph (c)(1) of the final rule provides that a fiduciary’s evaluation of an investment must be focused on pecuniary factors. Paragraph (c)(2) addresses investment alternatives that the fiduciary prudently determines would serve equivalent roles in the plan’s portfolio and that which the plan fiduciary is unable to distinguish on the basis of pecuniary factors alone. In such cases, a fiduciary may choose between such alternatives based on non-pecuniary factors provided the fiduciary documents (1) why the pecuniary factors were not sufficient to select the investment; (2) why the fiduciary believes diversification among the investments under consideration would not be prudent; and (3) how the chosen non-pecuniary factors are consistent with the interests of the plan. The Department continues to believe that the likelihood that a plan fiduciary will be unable to distinguish between two investment options based on pecuniary factors is rare; therefore, the need to document such circumstances also will be rare.<sup>103</sup> In those rare instances, the documentation requirement could be burdensome if fiduciaries are not currently documenting decisions. The Department estimates that this requirement will not result in a substantial cost burden, because it concludes that situations where plan

*regulations/rules-and-regulations/technical-appendices/labor-cost-inputs-used-in-ebsa-opr-ria-and-pra-burden-calculations-june-2019.pdf*.

<sup>103</sup> See Schanzenbach & Sitkoff, *supra* note 5, at 410 (describing a hypothetical pair of truly identical investments as a “unicorn”).

fiduciaries are unable to distinguish between alternative investment options based on pecuniary factors are rare. The cost for the documentation requirement is estimated to be \$122,000 annually. The estimation of this cost is discussed in the Paperwork Reduction Act (PRA) section.

The final rule provides that under no circumstances may any investment fund, product, or model portfolio be added as, or as a component of, a QDIA if its investment objectives or goals or its principal investment strategies include, consider, or indicate the use of one or more non-pecuniary factors. The final rule provides a transition provision requiring plans to bring their QDIAs into compliance with the final rule by April 30, 2022. This transition provision is intended to provide sufficient time for plans to review and make any necessary changes to their QDIAs to bring them into compliance. The Department believes as plans familiarize themselves with the rule, they are likely to make necessary changes. Accordingly, the Department assumes that associated costs will be incurred during the first year. The Department estimates that it will take on average 20 hours (in addition to any time fiduciaries customarily spend reviewing and changing their QDIAs) for fiduciaries of a plan offering QDIAs with exposure to non-pecuniary investment objectives to review and change their QDIAs resulting in a cost of \$1.1 million.<sup>104</sup>

The use of ESG investment alternatives in participant-directed plans has potential as a marketing tool that may increase retirement savings contributions for some investors. To the extent the rule reduces access to ESG investment alternatives retirement investors may reduce their future contributions. The Department is not aware of any empirical evidence assessing whether ESG investing is associated with increased rates of retirement savings.

<sup>104</sup>The Department estimated that there are 407,383 DC plans with QDIAs and that 0.1 percent, or 407 plans, will need to reconsider their QDIAs as a result of the rule. The burden is estimated as follows: (407,383 plans \* 0.001 \* 20 hours) = 814 hours. A labor rate of \$134.21 is used for a plan fiduciary. The cost burden is estimated as follows: (407,383 plans \* 0.001 \* 20 hours \* \$134.21) = \$1,092,469.40. Labor rates are based on DOL estimates from *Labor Cost Inputs Used in the Employee Benefits Security Administration, Office of Policy and Research’s Regulatory Impact Analyses and Paperwork Reduction Act Burden Calculation*, Employee Benefits Security Administration (June 2019), [www.dol.gov/sites/dolgov/files/EBSA/laws-and-regulations/rules-and-regulations/technical-appendices/labor-cost-inputs-used-in-ebsa-opr-ria-and-pra-burden-calculations-june-2019.pdf](http://www.dol.gov/sites/dolgov/files/EBSA/laws-and-regulations/rules-and-regulations/technical-appendices/labor-cost-inputs-used-in-ebsa-opr-ria-and-pra-burden-calculations-june-2019.pdf).

### 1.5. Uncertainty

It is unclear how many plan fiduciaries use non-pecuniary factors when selecting investments and the total asset value of investments that are selected in this manner, particularly for DB plans. While there is some survey evidence on how many DB plans factor in ESG considerations, the surveys were based on small samples and yielded varying results. It is also not clear whether survey information about ESG investing accurately represents the prevalence of investing that incorporates non-pecuniary factors. For instance, some non-pecuniary investing concentrates on issues that are not thought of as ESG-related. At the same time, some investment policies take account of environmental factors and corporate governance in a manner that focuses exclusively on the financial aspects of those considerations.

The final rule will replace the Department's existing sub-regulatory guidance on using non-pecuniary factors while selecting plan investments. It is very difficult to estimate how many plans have fiduciaries that are currently using non-pecuniary factors improperly while selecting investments. Such plans will experience significant effects from the final rule. It is also difficult to estimate the degree to which the use of non-pecuniary factors by ERISA fiduciaries, ESG or otherwise, would expand in the future absent this rulemaking, though trends in other countries suggest that pressure for such expansion will continue only to increase.<sup>105</sup> However, based on current trends the Department believes that the use of non-pecuniary factors by ERISA plan fiduciaries would likely increase moderately in the future without this rulemaking.

### 1.6. Alternatives

The Department considered several alternatives to the final regulation. One alternative would prohibit plan fiduciaries from ever considering ESG factors. This would address the Department's concerns that some plan fiduciaries may sacrifice return or increase investment risk to promote goals that are unrelated to the financial interests of the plan or its participants. However, the Department rejected this alternative, because it would prohibit fiduciaries from considering such factors even when the fiduciaries are

focused on the financial aspects rather than the non-pecuniary aspects of the investments.

The Department also considered prohibiting plan fiduciaries from basing investment decisions on non-pecuniary factors and prohibiting the use of non-pecuniary factors even where the alternative investment options cannot be distinguished based on pecuniary factors (the so-called "tie-breaker" provision). However, if the alternative investment options cannot be distinguished on the basis of pecuniary factors, it is not clear what factors would be available to a plan fiduciary to base its decision on other than a non-pecuniary factor. Regardless, the Department believes that investment options that cannot be distinguished on the basis of pecuniary factors occur very rarely in practice, if at all. Accordingly, this final rule provides that when choosing between investment alternatives that the fiduciary prudently determines would serve equivalent roles in the plan's portfolio or the portion of the portfolio over which the fiduciary has responsibility and which the plan fiduciary is unable to distinguish on the basis of pecuniary factors alone, the fiduciary may base the investment decision non-pecuniary factors provided the fiduciary documents the following: (1) Why the pecuniary factors were not sufficient to select the investment; (2) how the investment compares to alternative investments with regard to the factors listed in paragraphs (b)(2)(ii)(A) through (C) of the final rule; and (3) how the chosen non-pecuniary factors are consistent with the interests of the plan.

The Department notes that the proposal did not expressly incorporate the tie-breaker provision into the regulatory provision on selection of investment options for individual account plans. The Department explained in the proposal its perspective that the concept of "ties" may have little relevance in the context of fiduciaries' selection of menu options for individual account plans as such investment options are often chosen precisely for their varied characteristics and the range of choices they offer plan participants. Further, the Department explained that because the proposal did not restrict the addition of prudently selected, well managed investment options for individual account plans that include non-pecuniary factors if they can be justified solely on the basis of pecuniary factors, there would be little need for a tie-breaker between selected investment funds. Nonetheless, some commenters expressed uncertainty regarding the interaction of paragraph

(c)(2) and the provisions of the proposal on selecting investment options for individual account plans. Some commenters asked the Department to expressly make the tie-breaker available for such investment decisions.

Although the Department continues to doubt the relevance of a "tie" concept when adding investment alternatives to a platform of investments that allow participants and beneficiaries to choose from a broad range of investment alternatives as defined in 29 CFR 2550.404c-1(b)(3), the final rule makes the tie-breaker provisions in paragraph (c) generally available for use in selecting investment options for individual account plans in the event the fiduciaries of the plan believe that it gives them some added flexibility and fiduciary protection when adding an investment fund, product, or model portfolio that promotes, seeks, or supports one or more non-pecuniary goals.

Paragraph (d) of the final rule contains standards applicable to participant-directed individual account plans. The predecessor standards for participant-directed individual account plans were set forth in paragraph (c)(3) of the proposal. Paragraph (c)(3)(ii) of the proposal would have required plan fiduciaries to document their compliance with the requirement to use only objective risk-return criteria in the selection and monitoring of investment platforms or menu alternatives. The Department included the cost plan fiduciaries would incur to comply with this documentation requirement in its cost estimates for the proposal.

The Department considered including this documentation requirement in the final rule; however, it determined not to include such requirement in paragraph (d)(2) of the final rule. The Department was persuaded by some commenters' concerns that this requirement would have applied more stringent requirements to ESG investment alternatives than other types of investment alternatives. These commenters argued that it is inappropriate to impose separate documentation requirements that vary by investment strategy. Other commenters objected to this requirement on the grounds that it would increase costs to plans and potentially provide grounds for unwarranted class action lawsuits. The Department believes that the approach reflected in the final rule best reflects ERISA's statutory obligations of prudence and loyalty, appropriately ensures that small and large plan fiduciaries' decisions will be guided by the financial interests of the plans and

<sup>105</sup> See generally Government Accountability Office Report No. 18-398, *Retirement Plan Investing: Clearer Information on Consideration of Environmental, Social, and Governance Factors Would Be Helpful* (May 2018), at 25-27; Principles for Responsible Investment, *Fiduciary Duty in the 21st Century*, supra note 12, at 21-22, 50-51.

participants to whom they owe duties of prudence and loyalty, and is the most efficient alternative to apply and enforce.

### 1.7. Conclusion

The final rule describes when and how fiduciaries can fulfill their responsibilities by factoring in only pecuniary considerations when selecting and monitoring investments. Some plans and their service providers will incur costs to (1) review the rule and if necessary, modify their processes for selecting and monitoring investments, (2) make changes to their QDIA if it does not align with the final rule's requirements, and (3) document selections where alternative investment options cannot be distinguished on the basis of pecuniary factors. The Department does not expect these requirements to impose a significant cost increase. The final rule mitigates some costs by allowing plans to make any required changes to QDIAs when necessary to comply with the requirements of paragraph (d)(2) by April 30, 2022. The Department also believes cost will be mitigated, because circumstances where alternative investment options that cannot be distinguished based on pecuniary factors should occur very rarely in practice.

Although the final rule will replace its prior sub-regulatory guidance, the Department believes that there is significant overlap in the content of each. Overall, the final rule will assist fiduciaries in carrying out their responsibilities by avoiding making investment decisions based on non-pecuniary factors, while protecting the financial interests of participants and beneficiaries in their retirement benefits under their plans.

The Department estimates that the final rule would impose incremental costs of approximately \$44.9 million in the first year and \$122,000 in subsequent years. Over 10 years, the associated costs would be approximately \$42.7 million with an annualized cost of \$6.1 million, using a seven percent discount rate.<sup>106</sup> Using a perpetual time horizon (to allow the comparisons required under Executive Order 13771), the annualized costs in 2016 dollars are \$2.9 million at a seven percent discount rate.<sup>107</sup>

<sup>106</sup> The costs would be \$44.5 million over 10-year period with an annualized cost of \$5.2 million, applying a three percent discount rate.

<sup>107</sup> The annualized costs in 2016 dollars would be \$1.4 million applying a three percent discount rate.

### 1. Paperwork Reduction Act

In accordance with the Paperwork Reduction Act of 1995 (PRA 95) (44 U.S.C. 3506(c)(2)(A)), the Department solicited comments concerning the information collection request (ICR) included in the Financial Factors in Selecting Plan Investments ICR (85 FR 39113). At the same time, the Department also submitted an information collection request (ICR) to the Office of Management and Budget (OMB), in accordance with 44 U.S.C. 3507(d). OMB filed a comment on the proposed rule with the Department on August 25, 2020, requesting the Department to provide a summary of comments received on the ICR and identify changes to the ICR made in response to the comments. OMB did not approve the ICR, and requested the Department to file future submissions of the ICR under OMB control number 1210-0162.

The Department received several comments that specifically addressed the paperwork burden analysis of the information collection requirement contained in the proposed rule. The Department took into account such public comments in developing the revised paperwork burden analysis discussed below.

In connection with publication of this final rule, the Department is submitting an ICR to OMB requesting approval of a new collection of information under OMB Control Number 1210-0162. The Department will notify the public when OMB approves the ICR.

A copy of the ICR may be obtained by contacting the PRA addressee shown below or at [www.RegInfo.gov](http://www.RegInfo.gov). PRA ADDRESSEE: G. Christopher Cosby, Office of Regulations and Interpretations, U.S. Department of Labor, Employee Benefits Security Administration, 200 Constitution Avenue NW, Room N-5718, Washington, DC 20210; [cosby.chris@dol.gov](mailto:cosby.chris@dol.gov). Telephone: 202-693-8410; Fax: 202-219-4745. These are not toll-free numbers.

In prior guidance, the Department has encouraged plan fiduciaries to appropriately document their investment activities, and the Department believes it is common practice. The final rule expressly requires only that, where a plan fiduciary or its service provider determines that alternative investments are unable to be distinguished on the basis of pecuniary factors alone, the fiduciary or the plan's service provider further documents the basis for concluding that a distinguishing factor could not be found and the reason that

the investment was selected based on non-pecuniary factors. Nevertheless, the Department believes that the likelihood of two investment options that cannot be distinguished based on pecuniary factors is very rare.

While the incremental burden of the final regulation is small, the full burden of the requirements will be included below as required by the PRA to allow for evaluation of the requirements in the entire information collection.

According to the most recent Form 5500 data and other assumptions discussed in the affected entities section above, there are 8,905 DB plans and 17,676 DC plans with ESG investments that are not participant directed, and 52,378 participant-directed individual account plans.<sup>108</sup> These plans and their service providers could be affected by the final rule. While the Department does not have data regarding the frequency of the rare event of alternatives being not distinguished on the basis of pecuniary factors and requiring documentation, the Department models the burden using one percent of plans with ESG investments as needing to comply with the documentation requirement.

While DB plans may change investments at least annually, DC plans may do so less frequently. For this analysis, DC plans are assumed to review their service providers and investments about every three years. Therefore, the Department estimates that in a year, 89 DB plans and 59 DC plans with ESG investments that are not participant directed, and 175 participant-directed DC plans with ESG alternatives will encounter alternative investment options that cannot be distinguished on the basis of pecuniary factors.

#### 2.1. Maintain Documentation

The final rule requires ESG plan fiduciaries to maintain documentation when choosing between or among investment alternatives that the fiduciary prudently determines would serve equivalent roles in the plan's portfolio based on appropriate consideration of the investment and that the plan fiduciary is unable to distinguish on the basis of pecuniary factors and the fiduciary bases the investment decision on non-pecuniary factors. While much of the

<sup>108</sup> DOL calculations based on statistics from U.S. Department of Labor, Employee Benefits Security Administration, "Private Pension Plan Bulletin: Abstract of 2018 Form 5500 Annual Reports," (forthcoming 2020), (46,869 DB plans \* 19% = 8,905 DB plans; 93,033 DC Plans \* 19% = 17,676 DC plans; 581,974 \* 9% = 52,378 individual account plans with participant direction).

documentation needed to fulfill this requirement is generated in the normal course of business, plans may need additional time to ensure records are properly maintained and are up to the standard required by the Department.

Some commenters suggested that the Department underestimated the cost associated with documenting the required information. Specifically, they asserted that the Department underestimated the labor rates for attorneys and the time required to document the required information. The Department disagrees with both of these comments. Instead of using an attorney labor rate, the Department based its estimate on a plan fiduciary's labor rate, because this task could be performed by attorneys or other types of professionals including financial professionals. The labor rate estimates were based on estimates from the Bureau of Labor Statistics (BLS). While the Department understands that hiring outside services can come at a higher cost, the Department believes that using the BLS estimate is appropriate for purposes of this analysis.

Commenters claimed that the two hours estimated to document when alternative investments cannot be distinguished based on pecuniary factors underestimated the burden. The Department continues to believe that a prudent process required by ERISA should already include the burden of research and consideration. The burden associated with this ICR is for plan fiduciaries to meet the final rule's specific documentation requirement. In the final rule, the Department explicitly set forth the three items that must be documented. Stating precisely what is required to be documented should help lower the cost of compliance, because fiduciaries know the specific information that must be documented. In response to the comments, and to avoid underestimating the final rule's potential costs, the Department has not reduced the total estimated quantified costs although the research burden of the rule has been reduced.

The Department estimates that plan fiduciaries and clerical staff will each expend, on average, two hours of labor to maintain the needed documentation. This results in an annual burden estimate of 1,290 hours annually, with an equivalent cost of \$122,115 for DB plans and DC plans with ESG investments.<sup>109</sup> Plans that rely on

<sup>109</sup> The burden is estimated as follows: (8,905 DB plans \* 0.01 \* 2 hours) + (17,676 DC plans \* 0.01 \* 2 hours \* 0.33) + (52,378 DC plans with participant direction \* 0.01 \* 2 hours \* 0.33) = 645 hours for both a plan fiduciary and clerical staff for a total of 1,290. A labor rate of \$134.21 is used for

service providers may incur a lower cost due to economies of scale. However, the Department does not know exactly how many plans use a service provider; therefore, it estimated such costs on a per-plan basis.

The Department's paperwork burden estimate associated with the final rule is summarized as follows:

*Type of Review:* New collection.

*Agency:* Employee Benefits Security Administration, Department of Labor.

*Title:* Financial Factors in Selecting Plan Investments.

*OMB Control Number:* 1210-0162.

*Affected Public:* Businesses or other for-profits.

*Estimated Number of Respondents:* 323.

*Estimated Number of Annual Responses:* 323.

*Frequency of Response:* Occasionally.

*Estimated Total Annual Burden Hours:* 1,290.

*Estimated Total Annual Burden Cost:* \$0.

## 2. Regulatory Flexibility Act

The Regulatory Flexibility Act (RFA)<sup>110</sup> imposes certain requirements with respect to Federal rules that are subject to the notice and comment requirements of section 553(b) of the Administrative Procedure Act<sup>111</sup> and that are likely to have a significant economic impact on a substantial number of small entities. Unless the head of an agency determines that a final rule is not likely to have a significant economic impact on a substantial number of small entities, section 603 of the RFA requires the agency to present a final regulatory flexibility analysis of the final rule.

For purposes of analysis under the RFA, the Employee Benefits Security Administration (EBSA) continues to consider a small entity to be an employee benefit plan with fewer than 100 participants.<sup>112</sup> The basis of this definition is found in section 104(a)(2) of ERISA, which permits the Secretary of Labor to prescribe simplified annual reports for pension plans that cover fewer than 100 participants. Under

a plan fiduciary and a labor rate of \$55.14 for clerical staff ((8,905 DB plans \* 0.01 \* 2 \* \$134.21) + (17,676 DC plans \* 0.01 \* 2 hours \* 0.33 \* \$134.21)) + (52,378 DC plans with participant direction \* 0.01 \* 2 hours \* 0.33 \* \$134.21) + (8,905 DB plans \* 0.01 \* 2 \* \$55.14) + (17,676 DC plans \* 0.01 \* 2 hours \* 0.33 \* \$55.14) + (52,378 DC plans with participant direction \* 0.01 \* 2 hours \* 0.33 \* \$55.14) = \$122,115).

<sup>110</sup> 5 U.S.C. 601 *et seq.* (1980).

<sup>111</sup> 5 U.S.C. 551 *et seq.* (1946).

<sup>112</sup> The Department consulted with the Small Business Administration's Office of Advocacy before making this determination, as required by 5 U.S.C. 603(c) and 13 CFR 121.903(c).

section 104(a)(3), the Secretary may also provide for exemptions or simplified annual reporting and disclosure for welfare benefit plans. Pursuant to the authority of section 104(a)(3), the Department has previously issued—at 29 CFR 2520.104-20, 2520.104-21, 2520.104-41, 2520.104-46, and 2520.104b-10—certain simplified reporting provisions and limited exemptions from reporting and disclosure requirements for small plans. Such plans include unfunded or insured welfare plans covering fewer than 100 participants and satisfying certain other requirements. Further, while some large employers may have small plans, in general small employers maintain small plans. Thus, EBSA believes that assessing the impact of this final rule on small plans is an appropriate substitute for evaluating the effect on small entities. The definition of small entity considered appropriate for this purpose differs, however, from a definition of small business that is based on size standards promulgated by the Small Business Administration (SBA)<sup>113</sup> pursuant to the Small Business Act.<sup>114</sup> In its initial regulatory flexibility analysis for the proposal, the Department requested, but did not receive, comments on the appropriateness of the size standard used in evaluating the impact of the proposed rule on small entities.

The Department has determined that this final rule could have a significant impact on a substantial number of small entities. Therefore, the Department has prepared a Final Regulatory Flexibility Analysis that is presented below.

### 3.1. Need for and Objectives of the Rule

The final rule confirms that ERISA requires plan fiduciaries to select investments and investment courses of action based solely on financial considerations relevant to the risk-adjusted economic value of a particular investment or investment course of action. This will help ensure that fiduciaries are protecting the financial interests of participants and beneficiaries.

### 3.2. Affected Small Entities

The final rule has documentation provisions that will affect small ERISA-covered plans with fewer than 100 participants. It also contains provisions about the improper use of non-pecuniary factors when plan fiduciaries select and monitor investments. These provisions will affect only small plans that are improperly incorporating non-

<sup>113</sup> 13 CFR 121.201.

<sup>114</sup> 15 U.S.C. 631 *et seq.*

pecuniary factors into their investment decisions.

As discussed in the affected entities section above, surveys suggest that 19 percent of DB plans and DC plans with investments that are not participant directed and 9 percent of DC plans with participant directed individual accounts have ESG or ESG-themed investments. Plans with ESG or ESG-themed investments are used as a proxy of the number of plans that could be affected by the final rule. This represents approximately 8,905 DB plans and 70,054 DC plans. Additionally, surveys suggest 70 percent of DC plans with participant-directed individual accounts offer a QDIA. Of the 70 percent, the Department estimates that 0.1 percent have exposure to ESG investments, representing approximately 407 plans.

The distribution across plan size is not available in the surveys. It should be noted that 84 percent of all DB plans and 87 percent of all DC plans are small plans.<sup>115</sup> Applying these proportions uniformly, 7,480 small DB plans and 60,947 small DC plans are estimated to be affected by the rule. Particularly for DB plans, it is likely that most plans with ESG investments are large. In terms of the actual utilization of ESG options, about 0.1 percent of total DC plan assets are invested in ESG funds.<sup>116</sup> In addition, one survey found that among 401(k) plans with fewer than 50 participants, approximately 1.7 percent offered an ESG investment option.<sup>117</sup> Therefore, a large majority of small plan participants do not have an ESG fund in their portfolio.

One commenter suggested that the Department underestimated the percent of small DC plans that offer an ESG investment option. The commenter asserted that their data analysis indicates that 14.5 percent of corporate DC plans with fewer than 50 participants have an ESG option. The experience of one service provider is insightful, but may not be representative of the industry as a whole. While the Department appreciates the input, the commenter did not provide the data source for their statistic. Thus, the

Department could not access the validity of the data and general applicability of the statistic. The Department did consider the statistic when reevaluating its estimates, and when combined with other data points, raised its estimate from six percent to nine percent of DC plans with individual accounts where a plan fiduciary could not distinguish investment alternatives based on pecuniary factors and such fiduciary is required to document its use of a non-pecuniary factor.

One commenter was concerned that the Department did not survey plan participants and fiduciaries in order to estimate the cost incurred by the plan. While the Department acknowledges this concern, the Department used survey data from the Plan Sponsor Council of America to estimate the percent of small DC plans that offer an ESG investment option. The Department believes that the impact of the rule has been accurately assessed.

Other general comments about the final rule and its impacts are discussed elsewhere in the preamble.

3.3. Impact of the Rule

While the rule is expected to affect small pension plans, it is unlikely there will be a significant economic impact on many of these plans. The final regulation provides guidance on how fiduciaries can comply with section 404(a)(1)(B) of ERISA when investing plan assets. The Department believes most plans are already fulfilling the requirement in the course of following the Department's prior sub-regulatory guidance.

The Department expects some small plans to experience rising costs from three potential sources. The first cost is associated with the time required for plan fiduciaries to review the rule and amending investment policy statements to reflect it. The second cost is associated with the requirement for plan fiduciaries to document selections of investments based on non-pecuniary factors where the alternative investment options are unable to be distinguished

on the basis of pecuniary factors alone. The third cost is associated with the final rule's provision prohibiting plan fiduciaries from adding any investment fund, product, or model portfolio as, or as a component of, a QDIA if its investment objectives or goals or its principal investment strategies include, consider, or indicate the use of one or more non-pecuniary factors. The final rule allows for a transition period for plans to review and make necessary changes to pre-existing QDIAs; however, as discussed in the regulatory impact analysis, the Department assumes that associated costs will be incurred during the first year.

As illustrated in Table 1 below, the Department estimates a cost of \$3,599.74 per affected plan in year 1 and \$379 per affected plan in year two for plan fiduciaries and clerical professionals to become familiar with the final rule, fulfill the documentation requirement, and review their QDIA holdings. These costs reflect an instance in which (1) a plan has exposure to investments with non-pecuniary investment objectives, (2) a plan fiduciary uses a non-pecuniary factor to make an investment decision between investments that cannot be distinguished on the basis of pecuniary factors, and (3) a plan offers a QDIA in which the QDIA, or component of the QDIA, considers, or indicates the use of, one or more non-pecuniary factors in its investment objectives or goals or its principal investment strategies. As discussed throughout the regulatory impact analysis, most plans will only incur the rule familiarization costs, while few plans will incur both costs (2) and (3). Plans needing to provide documentation will be rare, because tie-breakers rarely occur, and only an estimated 0.1 percent of plans need to update their QDIA holdings, because the QDIA or a component thereof, includes, considers, or indicates the use of, one or more non-pecuniary factors in its investment objectives or goals or its principal investment strategies.

TABLE 1—COSTS FOR PLANS TO COMPLY WITH REQUIREMENTS

Affected entity	Labor rate	Hours	Year 1 cost	Year 2 cost
Documentation: Plan Fiduciary .....	\$134.21	2	\$268.42	\$268.42
Documentation: Clerical workers .....	55.14	2	110.28	110.28
Rule Familiarization: Plan Fiduciary .....	134.21	4	536.84	0
Update QDIA Holdings: Plan Fiduciary .....	134.21	20	2,684.20	0

<sup>115</sup> DOL calculations based on statistics from U.S. Department of Labor, Employee Benefits Security Administration, "Private Pension Plan Bulletin:

Abstract of 2018 Form 5500 Annual Reports," (forthcoming 2020).

<sup>116</sup> 62nd Annual Survey of Profit Sharing and 401(k) Plans, Plan Sponsor Council of America (2019).

<sup>117</sup> *Id.*



TABLE 1—COSTS FOR PLANS TO COMPLY WITH REQUIREMENTS—Continued

Affected entity	Labor rate	Hours	Year 1 cost	Year 2 cost
Total: Plans Needing Familiarization Only .....	.....	.....	536.84	0
Total: Plans Needing to Update QDIA and Provide Documentation .....	.....	.....	3,599.74	\$378.70

Source: DOL calculations based on statistics from *Labor Cost Inputs Used in the Employee Benefits Security Administration, Office of Policy and Research's Regulatory Impact Analyses and Paperwork Reduction Act Burden Calculation*, Employee Benefits Security Administration (June 2019), [www.dol.gov/sites/dolgov/files/EBSA/laws-and-regulations/rules-and-regulations/technical-appendices/labor-cost-inputs-used-in-ebsa-opria-and-pra-burden-calculations-june-2019.pdf](http://www.dol.gov/sites/dolgov/files/EBSA/laws-and-regulations/rules-and-regulations/technical-appendices/labor-cost-inputs-used-in-ebsa-opria-and-pra-burden-calculations-june-2019.pdf).

Small plans affected by the rule—those with exposure to investments considering non-pecuniary factors—would incur a cost associated with the time to review the rule and amend relevant investment policy statements. The Department estimates that nine percent of plans would fall into this category. Additionally, the Department believes small plans are likely to rely on service providers to monitor regulatory changes and make necessary changes to the plan. Overall, the Department expects the costs associated with the familiarization of the rule to be small on a per-plan basis.

As stated above, the final rule also prohibits plan fiduciaries from adding any investment fund, product, or model portfolio as, or as a component of, a QDIA if its investment objectives or goals or its principal investment strategies include, consider, or indicate the use of one or more non-pecuniary factors. While the cost in the table above reflects a cost for participant-directed individual account plans with exposure to investments with non-pecuniary objectives, the Department believes this is likely to affect few small plans. The Department estimates that 0.1 percent of all plans would need to reassess their QDIAs; however, as the Department believes small plans are likely to rely on service providers to propose compliant QDIAs, this estimate likely represents an upper bound of the burden on affected small entities. Further, the Department believes service providers should be familiar with the available target-date funds and be able to propose an alternative, compliant QDIA without expending material resources. As discussed above, this restriction will affect small plans; however, the Department expects that a minimal burden will be imposed on a small number of them.

### 3.4. Regulatory Alternatives

As discussed above in this preamble, the final regulation reiterates and codifies long-established principles of fiduciary standards for selecting and monitoring investments, and thus seeks to provide clarity and certainty

regarding the scope of fiduciary duties surrounding non-pecuniary issues. These standards apply to all affected entities, both large and small; therefore, the Department's ability to craft specific alternatives for small plans is limited.

The Department carefully considered the final rule's impact on small entities by analyzing other alternatives for the proposal. One alternative would prohibit plan fiduciaries from ever considering ESG or similar factors. This would address the Department's concerns that some plan fiduciaries may sacrifice return or increase investment risk to promote goals that are unrelated to the financial interests of the plan or its participants. However, the Department rejected this alternative, because it would prohibit fiduciaries from considering such factors even when the fiduciaries are focused on the financial aspects rather than the non-pecuniary aspects of the investments.

The Department also has considered prohibiting plan fiduciaries from basing investment decisions on non-pecuniary factors and prohibiting the use of non-pecuniary factors even where plan fiduciaries cannot distinguish alternative investment options based on pecuniary factors. But if the alternative investment options cannot be distinguished on the basis of pecuniary factors, it is unclear what factors would be available for a plan fiduciary to base its decision on other than non-pecuniary factors. Regardless, the Department believes this circumstance occurs very rarely in practice, if at all. Accordingly, this final rule retains the "all things being equal" test from the Department's previous guidance with a specific requirement for plan fiduciaries to document (1) why the pecuniary factors were not sufficient to select the investment; (2) how the investment compares to alternative investments with regard to the factors listed in paragraphs (b)(2)(ii)(A) through (C) of the final rule; and (3) how the chosen non-pecuniary factors are consistent with the interests of participants and beneficiaries in their retirement income or financial benefits under the plan.

The Department notes that the proposal did not expressly incorporate the tie-breaker provision into the regulatory provision on selection of investment options for individual account plans. The Department explained in the proposal its perspective that the concept of "ties" may have little relevance in the context of fiduciaries' selection of menu options for individual account plans as such investment options are often chosen precisely for their varied characteristics and the range of choices they offer plan participants. Further, the Department explained that because the proposal did not restrict the addition of prudently selected, well-managed investment options for individual account plans that include non-pecuniary factors if they can be justified solely on the basis of pecuniary factors, there would be little need for a tie-breaker between selected investment funds. Nonetheless, some commenters expressed some uncertainty regarding the interaction of paragraph (c)(2) and the provisions of the proposal on selecting investment options for individual account plans. Some commenters asked the Department to expressly make the tie-breaker available for such investment decisions.

Although the Department continues to doubt the relevance of a "tie" concept when adding investment alternatives to a platform of investments that allow participants and beneficiaries to choose from a broad range of investment alternatives as defined in 29 CFR 2550.404c-1(b)(3), the final rule makes the tie-breaker provisions in paragraph (c) generally available for use in selecting investment options for individual account plans in the event the fiduciaries of the plan believe that it gives them some added flexibility and fiduciary protection when adding an investment fund, product, or model portfolio that promotes, seeks, or supports one or more non-pecuniary goals.

Paragraph (d) of the final rule contains standards applicable to participant-directed individual account plans. The predecessor standards for

participant-directed individual account plans were set forth in paragraph (c)(3) of the proposal. Paragraph (c)(3)(ii) of the proposal would have required plan fiduciaries to document their compliance with the requirement to use only objective risk-return criteria in the selection and monitoring of investment platform or menu alternatives. The Department included the cost plan fiduciaries would incur to comply with this documentation requirement in its cost estimates for the proposal.

The Department considered including this document requirement in the final rule; however, it determined not to include such requirement in paragraph (d)(2) of the final rule. The Department was persuaded by some commenters' concerns that this requirement would have applied more stringent requirements to ESG investment alternatives than other types of investment alternatives. These commenters argued that it is inappropriate to impose separate documentation requirements that vary by investment strategy. Other commenters objected to this requirement on the grounds that it would increase costs to plans and potentially provide grounds for unwarranted class action lawsuits.

The Department believes that the approach taken in the final rule best reflects the statutory obligations of prudence, appropriately ensures that large and small plan fiduciaries' decisions would be guided by the financial interests of the plans and participants to whom they owe duties of prudence, and is the most efficient alternative to apply and enforce.

### 3.5. Duplicate, Overlapping, or Relevant Federal Rules

The Department is issuing this final rule under sections 404(a)(1)(A) and 404(a)(1)(B) of Title I under ERISA. The Department has sole jurisdiction to interpret these provisions as they apply to plan fiduciaries' consideration of non-pecuniary factors in selecting plan investment funds. Therefore, there are no duplicate, overlapping, or relevant Federal rules.

### 4. Unfunded Mandates Reform Act

Title II of the Unfunded Mandates Reform Act of 1995 (Pub. L. 104-4) requires each Federal agency to prepare a written statement assessing the effects of any Federal mandate in a proposed or final agency rule that may result in an expenditure of \$100 million or more (adjusted annually for inflation with the base year 1995) in any one year by state, local, and tribal governments, in the aggregate, or by the private sector. For

purposes of the Unfunded Mandates Reform Act, as well as Executive Order 12875, this final rule does not include any Federal mandate that the Department expects would result in such expenditures by state, local, or tribal governments.

### 5. Federalism Statement

Executive Order 13132 outlines fundamental principles of federalism and requires the adherence to specific criteria by Federal agencies in the process of their formulation and implementation of policies that have "substantial direct effects" on the states, the relationship between the National Government and the states, or on the distribution of power and responsibilities among the various levels of government.<sup>118</sup> Federal agencies promulgating regulations that have federalism implications must consult with state and local officials, and describe the extent of their consultation and the nature of the concerns of state and local officials in the preamble to the final rule.

In the Department's view, this final regulation does not have federalism implications because it will not have direct effects on the states, the relationship between the National Government and the states, or on the distribution of power and responsibilities among various levels of government. Section 514 of ERISA provides, with certain exceptions specifically enumerated, that the provisions of Titles I and IV of ERISA supersede any and all laws of the states as they relate to any employee benefit plan covered under ERISA. The requirements implemented in the final rule do not alter the fundamental reporting and disclosure requirements of the statute with respect to employee benefit plans, and as such have no implications for the states or the relationship or distribution of power between the National Government and the states.

### Statutory Authority

This regulation is finalized pursuant to the authority in section 505 of ERISA (Pub. L. 93-406, 88 Stat. 894; 29 U.S.C. 1135) and section 102 of Reorganization Plan No. 4 of 1978 (43 FR 47713, October 17, 1978), effective December 31, 1978 (44 FR 1065, January 3, 1979), 3 CFR 1978 Comp. 332, and under Secretary of Labor's Order No. 1-2011, 77 FR 1088 (Jan. 9, 2012).

<sup>118</sup>Federalism, 64 FR 153 (Aug. 4, 1999).

### List of Subjects in 29 CFR Parts 2509 and 2550

Employee benefit plans, Employee Retirement Income Security Act, Exemptions, Fiduciaries, Investments, Pensions, Prohibited transactions, Reporting and Recordkeeping requirements, Securities.

For the reasons set forth in the preamble, the Department amends parts 2509 and 2550 of subchapters A and F of chapter XXV of title 29 of the Code of Federal Regulations as follows:

#### Subchapter A—General

#### PART 2509—INTERPRETIVE BULLETINS RELATING TO THE EMPLOYEE RETIREMENT INCOME SECURITY ACT OF 1974

- 1. The authority citation for part 2509 continues to read as follows:

**Authority:** 29 U.S.C. 1135. Secretary of Labor's Order 1-2003, 68 FR 5374 (Feb. 3, 2003). Sections 2509.75-10 and 2509.75-2 issued under 29 U.S.C. 1052, 1053, 1054. Sec. 2509.75-5 also issued under 29 U.S.C. 1002. Sec. 2509.95-1 also issued under sec. 625, Pub. L. 109-280, 120 Stat. 780.

#### § 2509.2015-01 [Removed]

- 2. Remove § 2509.2015-01.

#### Subchapter F—Fiduciary Responsibility under the Employee Retirement Income Security Act of 1974

#### PART 2550—RULES AND REGULATIONS FOR FIDUCIARY RESPONSIBILITY

- 3. The authority citation for part 2550 continues to read as follows:

**Authority:** 29 U.S.C. 1135 and Secretary of Labor's Order No. 12011, 77 FR 1088 (January 9, 2012). Sec. 102, Reorganization Plan No. 4 of 1978, 5 U.S.C. App. at 727 (2012). Sec. 2550.401c-1 also issued under 29 U.S.C. 1101. Sec. 2550.404a-1 also issued under sec. 657, Pub. L. 107-16, 115 Stat. 38. Sec. 2550.404a-2 also issued under sec. 657 of Pub. L. 107-16, 115 Stat. 38. Sections 2550.404c-1 and 2550.404c-5 also issued under 29 U.S.C. 1104. Sec. 2550.408b-1 also issued under 29 U.S.C. 1108(b)(1). Sec. 2550.408b-19 also issued under sec. 611, Pub. L. 109-280, 120 Stat. 780, 972. Sec. 2550.412-1 also issued under 29 U.S.C. 1112.

- 4. Revise § 2550.404a-1 to read as follows:

#### § 2550.404a-1 Investment duties.

(a) *In general.* Section 404(a)(1)(A) and 404(a)(1)(B) of the Employee Retirement Income Security Act of 1974, as amended (ERISA or the Act) provide, in part, that a fiduciary shall discharge that person's duties with respect to the plan solely in the interests of the participants and beneficiaries, for the

exclusive purpose of providing benefits to participants and their beneficiaries and defraying reasonable expenses of administering the plan, and with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person 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.

(b) *Investment duties.* (1) With regard to the consideration of an investment or investment course of action taken by a fiduciary of an employee benefit plan pursuant to the fiduciary's investment duties, the requirements of section 404(a)(1)(B) of the Act set forth in paragraph (a) of this section are satisfied if the fiduciary:

(i) Has given appropriate consideration to those facts and circumstances that, given the scope of such fiduciary's investment duties, the fiduciary knows or should know are relevant to the particular investment or investment course of action involved, including the role the investment or investment course of action plays in that portion of the plan's investment portfolio with respect to which the fiduciary has investment duties; and

(ii) Has acted accordingly.

(2) For purposes of paragraph (b)(1) of this section, "appropriate consideration" shall include, but is not necessarily limited to:

(i) A determination by the fiduciary that the particular investment or investment course of action is reasonably designed, as part of the portfolio (or, where applicable, that portion of the plan portfolio with respect to which the fiduciary has investment duties), to further the purposes of the plan, taking into consideration the risk of loss and the opportunity for gain (or other return) associated with the investment or investment course of action compared to the opportunity for gain (or other return) associated with reasonably available alternatives with similar risks; and

(ii) Consideration of the following factors as they relate to such portion of the portfolio:

(A) The composition of the portfolio with regard to diversification;

(B) The liquidity and current return of the portfolio relative to the anticipated cash flow requirements of the plan; and

(C) The projected return of the portfolio relative to the funding objectives of the plan.

(3) An investment manager appointed, pursuant to the provisions of section 402(c)(3) of the Act, to manage all or part of the assets of a plan, may, for purposes of compliance with the

provisions of paragraphs (b)(1) and (2) of this section, rely on, and act upon the basis of, information pertaining to the plan provided by or at the direction of the appointing fiduciary, if—

(i) Such information is provided for the stated purpose of assisting the manager in the performance of the manager's investment duties; and

(ii) The manager does not know and has no reason to know that the information is incorrect.

(c) *Investments based on pecuniary factors.* (1) A fiduciary's evaluation of an investment or investment course of action must be based only on pecuniary factors, except as provided in paragraph (c)(2) of this section. A fiduciary may not subordinate the interests of the participants and beneficiaries in their retirement income or financial benefits under the plan to other objectives, and may not sacrifice investment return or take on additional investment risk to promote non-pecuniary benefits or goals. The weight given to any pecuniary factor by a fiduciary should appropriately reflect a prudent assessment of its impact on risk-return.

(2) Notwithstanding the requirements of paragraph (c)(1) of this section, when choosing between or among investment alternatives that the plan fiduciary is unable to distinguish on the basis of pecuniary factors alone, the fiduciary may use non-pecuniary factors as the deciding factor in the investment decision provided that the fiduciary documents:

(i) Why pecuniary factors were not sufficient to select the investment or investment course of action;

(ii) How the selected investment compares to the alternative investments with regard to the factors listed in paragraphs (b)(2)(ii)(A) through (C) of this section; and

(iii) How the chosen non-pecuniary factor or factors are consistent with the interests of participants and beneficiaries in their retirement income or financial benefits under the plan.

(d) *Investment alternatives for participant-directed individual account plans.* (1) The standards set forth in paragraphs (a) and (c) of this section apply to a fiduciary's selection or retention of designated investment alternatives available to participants and beneficiaries in an individual account plan.

(2) In the case of selection or retention of investment alternatives for an individual account plan that allows plan participants and beneficiaries to choose from a broad range of investment alternatives as defined in § 2550.404c-1(b)(3), a fiduciary is not prohibited from considering or including an

investment fund, product, or model portfolio as a designated investment alternative solely because the fund, product, or model portfolio promotes, seeks, or supports one or more non-pecuniary goals, provided that:

(i) The fiduciary satisfies the requirements of paragraphs (a) and (c) of this section in selecting or retaining any such investment fund, product, or model portfolio; and

(ii) The investment fund, product, or model portfolio is not added or retained as, or as a component of, a qualified default investment alternative described in § 2550.404c-5 if its investment objectives or goals or its principal investment strategies include, consider, or indicate the use of one or more non-pecuniary factors.

(e) [Reserved]

(f) *Definitions.* For purposes of this section:

(1) The term *investment duties* means any duties imposed upon, or assumed or undertaken by, a person in connection with the investment of plan assets which make or will make such person a fiduciary of an employee benefit plan or which are performed by such person as a fiduciary of an employee benefit plan as defined in section 3(21)(A)(i) or (ii) of the Act.

(2) The term *investment course of action* means any series or program of investments or actions related to a fiduciary's performance of the fiduciary's investment duties, and includes the selection of an investment fund as a plan investment, or in the case of an individual account plan, a designated investment alternative under the plan.

(3) The term *pecuniary factor* means a factor that a fiduciary prudently determines is expected to have a material effect on the risk and/or return of an investment based on appropriate investment horizons consistent with the plan's investment objectives and the funding policy established pursuant to section 402(b)(1) of ERISA.

(4) The term *plan* means an employee benefit plan to which Title I of the Act applies.

(5) The term *designated investment alternative* means any investment alternative designated by the plan into which participants and beneficiaries may direct the investment of assets held in, or contributed to, their individual accounts. The term "designated investment alternative" shall not include "brokerage windows," "self-directed brokerage accounts," or similar plan arrangements that enable participants and beneficiaries to select investments beyond those designated by the plan.

(g) *Effective date.* (1) This section shall be effective on January 12, 2021, and shall apply in its entirety to all investments made and investment courses of action taken after January 12, 2021.

(2) Plans shall have until April 30, 2022 to make any changes to qualified default investment alternatives described in § 2550.404c-5, where necessary to comply with the

requirements of paragraph (d)(2) of this section.

(h) *Severability.* If any provision of this section is held to be invalid or unenforceable by its terms, or as applied to any person or circumstance, or stayed pending further agency action, the provision shall be construed so as to continue to give the maximum effect to the provision permitted by law, unless such holding shall be one of invalidity or unenforceability, in which event the

provision shall be severable from this section and shall not affect the remainder thereof.

Signed at Washington, DC, this 30th day of October 2020.

**Jeanne Klinefelter Wilson,**

*Acting Assistant Secretary, Employee Benefits Security Administration, Department of Labor.*

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