

Memorandum

DOL Proposed Rule Would Impose Significant Limitations on the Use of ESG Considerations in Selecting ERISA Plan Investments

June 30, 2020

On June 23, 2020, the Department of Labor (the “DOL”) issued a proposed regulation (the “Proposed Rule”) to address when and how plan fiduciaries subject to the Employee Retirement Income Security Act of 1974, as amended (“ERISA”) can consider environmental, social, and corporate governance (“ESG”) factors in selecting plan investments. This Proposed Rule builds on previous guidance issued by the DOL in the form of Field Assistance Bulletins. The Proposed Rule was issued in response to increasing interest by institutional investors in considering ESG-related factors when making investments. The DOL made clear in the preamble to the Proposed Rule that, with limited exceptions, it is not supportive of these types of considerations because of a concern that fiduciaries are over-emphasizing ESG factors at the expense of factors that more directly bear on the financial risks and returns of a particular investment. Notably, the Proposed Rule could apply to the fiduciaries (*e.g.*, general partners or investment managers) of private equity funds that are deemed to hold plan assets.

History of Guidance. Over the past 26 years, the DOL has provided plan fiduciaries guidance on ESG-related investment issues in only four Field Assistance Bulletins.¹ In each case, the DOL started with a consistent position that “plan fiduciaries when making decisions on investments and investment courses of action must be focused solely on the plan’s financial risks and returns, and the interests of plan participants and beneficiaries in their plan benefits must be paramount.” However, the DOL previously recognized two instances when ESG factors may properly be considered:

1. **Tie Breaker Test.** If investment options have similar risk profiles and rates of return, a prudent fiduciary could consider non-financial factors, including ESG, when selecting an investment option. This is known as the “all things being equal” test or “tie breaker” test.
2. **ESG as a Financial Factor.** To the extent an ESG factor bears specifically on the financial risks and/or return of an investment, the ESG factor could be considered as primary consideration in whether or not to select the investment option.

¹ See Field Assistance Bulletin No. 94-1, 59 FR 32606 (June 23, 1994); Field Assistance Bulletin No. 2008-01, 73 FR 61734 (Oct. 17, 2008); Field Assistance Bulletin No. 2015-01, 80 FR 65135 (Oct. 26, 2015); Field Assistance Bulletin No. 2018-01 (Apr. 23, 2018).

Proposed Rule’s Impact on Prior Guidance and Regulations. In a departure from the issuance of Field Assistance Bulletins, the DOL proposed to amend the regulations issued under Section 404(a) of ERISA to provide guidance on the extent to which ESG may be considered by ERISA plan fiduciaries in making investment selections. The Proposed Rule distinguishes between the consideration of pecuniary versus non-pecuniary factors—defining a “pecuniary factor” 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 funding policy...” The Proposed Rule builds on the guidance provided by the Field Assistance Bulletins in the following small but meaningful ways:

- **Pecuniary Versus Non-Pecuniary Factors.** A fiduciary’s evaluation of investment options must be focused only on pecuniary factors. In assessing ESG attributes of a potential investment and whether they may be considered to be pecuniary in nature, a determination would have to be made that such attributes are reasonably expected to have a material positive effect on the risk and/or return of the investment based on a “prudent assessment of their impact on risk and return.”
- **Pecuniary Factors to be Considered.** The Proposed Rule provides a list of pecuniary factors that should be considered when comparing investments during the fiduciary process, including, but not limited to, how the investment contributes to diversification, liquidity and current return of the investment relative to anticipated cash flow requirements of the plan, and projected return of the investment relative to the funding objectives.
- **Tie Breaker Test.** When investment options are economically indistinguishable, a plan fiduciary can use the “tie breaker” test. However, the fiduciary must document why the investment options were indistinguishable and why the investment was selected based on the purposes of the plan, diversification of investments, and interests of the plan participants. In the preamble, the DOL indicates it expects that ties will “rarely, if ever, occur.”
- **Investment Alternatives for Individual Account Plans.** The Proposed Rule builds on guidance from 2018 for ESG investments in individual account plans (*e.g.*, 401k plans). A fiduciary can add a prudently selected, well-managed ESG-oriented investment option to an individual account plan investment menu, if:
 - the fiduciary uses only objective risk-return criteria in selecting and monitoring all investment alternatives for the plan, including any ESG investment alternatives;
 - the fiduciary documents its selection and monitoring of the investment; and
 - the ESG investment alternative is not added as, or as a component of, a qualified default investment alternative.

Potential Application to Private Equity Funds. To the extent private equity funds are not managing plan assets, general partners should consider how they market the private equity fund to potential investors subject to ERISA, understanding that ERISA fiduciaries will primarily need to consider pecuniary factors over ESG factors in making investment decisions. For general partners managing private equity funds subject to ERISA, this

Proposed Rule potentially has more direct application, as the general partner is an ERISA fiduciary. In such cases, to the extent ESG is considered when making an investment, the general partner should take care to appropriately document how the ESG factors serve as a tie breaker or, more likely, bear on the pecuniary analysis.

For further information regarding this memorandum, please contact one of the following:

NEW YORK CITY

Andrew Blau
+1-212-455-2380
andrew.blau@stblaw.com

Gregory T. Grogan
+1-212-455-2477
ggrogan@stblaw.com

Jeannine McSweeney
+1-212-455-3349
jeannine.mcsweeney@stblaw.com

Laurence M. Moss
+1-212-455-2280
larry.moss@stblaw.com

Brian D. Robbins
+1-212-455-3090
brobbs@stblaw.com

David E. Rubinsky
+1-212-455-2493
drubinsky@stblaw.com

Jeanne M. Annarumma
+1-212-455-7395
jannarumma@stblaw.com

Jamin R. Koslowe
+1-212-455-3514
jkoslowe@stblaw.com

Jennifer A. Neilsson
+1-212-455-3982
jennifer.neilsson@stblaw.com

PALO ALTO

Tristan Brown
+1-650-251-5140
tbrown@stblaw.com

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