

# A SUMMARY: DOL Final Rule on Financial Factors in Selecting Plan Investments



## ERISA FIDUCIARY DUTY – A RE-INTRODUCTION

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.

**PRUDENCE:** ERISA<sup>1</sup> requires plan fiduciaries to 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.

**SOLE INTEREST & EXCLUSIVE PURPOSE:** ERISA requires 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.

**EXCLUSIVE PURPOSE DEFINED:** 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>2</sup> observing that their decisions must “**be made with an eye single to the interests of the participants and beneficiaries.**”<sup>3</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>4</sup>

**DOL GUIDANCE ON NON-PECUNIARY BENEFITS:** The DOL’s first comprehensive guidance addressing plan investments selected because of the non-pecuniary benefits was in Interpretive Bulletin 94–1. The DOL’s objective was to state that “economically targeted investments” (ETIs) are not inherently incompatible with ERISA’s fiduciary obligations. DOL stated that the requirements of ERISA sections 403 and 404 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. Since then this approach has been referred to this as the “**all things being equal**” test or the “**tie-breaker**” standard. This means 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.

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<sup>1</sup> Sections 403(c) and 404(a)

<sup>2</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>3</sup> *Donovan v. Bierwirth*, 680 F.2d 263, 271 (2d Cir. 1982).

<sup>4</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).

## DOL CONCERNS

- 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.
- Some investment products may be marketed to ERISA fiduciaries on the basis of purported benefits and goals **unrelated to financial performance**.
- There may be **confusion** in this subject matter perhaps due in part to varied statements the DOL has made on the use of non-pecuniary or non-financial factors over the years in sub-regulatory guidance.

## DOL POSITION

The DOL reinforces principles of fiduciary standards for selecting and monitoring investments, and set forth the scope of fiduciary duties surrounding non-pecuniary issues. 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 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. ERISA fiduciaries must never sacrifice investment returns, take on additional investment risk, or pay higher fees to promote non-pecuniary benefits or goals.

ERISA plan fiduciaries may not subordinate return or increase risks to promote non-pecuniary objectives. The duty of loyalty requires those serving as fiduciaries to act with a single-minded focus on the interests of beneficiaries.

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.

## DOL OBJECTIVES

To set forth a regulatory structure to assist ERISA fiduciaries in navigating 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 risk

to promote non-pecuniary benefits or objectives.

The DOL 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.

## THE FINAL RULE UPDATES/AFFIRMS THE PROPOSED 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

1. in making investment decisions of any kind, ERISA requires that both the principles of loyalty<sup>5</sup> and of prudence<sup>6</sup> must be considered. The final rule expressly applies these principles not just to investments and investment courses of action<sup>7</sup>, but also to the selection of available investment options for plan participants in individual account plans.
2. Five amendments to investment duties regulation:
  - a. 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.
  - b. an express regulatory provision stating that compliance with the exclusive purpose (loyalty) duty<sup>8</sup> prohibits fiduciaries from
    - i. subordinating the interests of participants to unrelated objectives, and
    - ii. sacrificing investment return or taking on additional investment risk to promote non-pecuniary goals.
  - c. a provision that requires fiduciaries to consider reasonably available alternatives to meet their prudence and loyalty duties under ERISA.
  - d. sets forth required investment analysis and **written 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.
  - e. 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.

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, 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:

- i. the ERISA prudence and loyalty provisions, and
- ii. the requirement to evaluate solely on pecuniary factors, in selecting any such investment fund, product, or model portfolio.

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<sup>5</sup>section 404(a)(1)(A)

<sup>6</sup>section 404(a)(1)(B)

<sup>7</sup> Investment courses of action defined in paragraph (f)(2) of the final rule: “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.”

<sup>8</sup> section 404(a)(1)(A)

However, **the provision prohibits** plans from adding any investment fund, product, or model portfolio as a **qualified default investment alternative**<sup>9</sup>, 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.**

## FINAL RULE SUMMARIZED

### 1. Investment Duties<sup>10</sup>

Duties deemed satisfied if the fiduciary:

- a) Has acted accordingly after 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,
- b) “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, 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:
    - o The composition of the portfolio with regard to diversification;
    - o The liquidity and current return of the portfolio relative to the anticipated cash flow requirements of the plan; and
    - o The projected return of the portfolio relative to the funding objectives of the plan.

### 2. Investment based on Pecuniary Factors<sup>11</sup>

- a) evaluation of an investment or investment course of action must be based only on pecuniary factors, except as provided in b) below 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.
- b) 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-

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<sup>9</sup> a qualified default 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.

<sup>10</sup> 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.

<sup>11</sup> Pecuniary Factors 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.

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 under the 3 factors listed under items (b) “Appropriate consideration” section ii; 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.
3. Investment alternatives for **participant-directed individual account plans**.
- In addition to satisfying conditions set forth under Fiduciary Duties and Investment Based on Pecuniary Factors summarized above, for an individual account plan that allows plan participants to choose from a broad range of investment alternatives<sup>12</sup>, 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 under the 3 factors listed under items (b) “Appropriate consideration” section ii 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<sup>13</sup> if its investment objectives or goals or its principal investment strategies include, consider, or indicate the use of one or more non-pecuniary factors.

## EFFECTIVE DATE

This final rule 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.

Plans shall have until April 30, 2022, to make any changes to qualified default investment alternatives described in § 2550.404c-5.

<https://www.federalregister.gov/documents/2020/11/13/2020-24515/financial-factors-in-selecting-plan-investments>

This summary, prepared by Philip Chao, Experiential Wealth, is for general informational purpose only and should not be deemed as delivering any legal or regulatory guidance or fiduciary investment advice regarding the subject matter. Please refer to the final rule in its entirety for a more complete understanding and application. Please consult with legal and regulatory counsel and competent fiduciary investment advisor/consultant before taking any action.

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<sup>12</sup> defined in § 2550.404c1(b)(3)

<sup>13</sup> defined in § 2550.404c-5