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Employee Benefits Update

July 17, 2020

DOL Issues Guidance on Investment Duties of Retirement Plan Fiduciaries

Executive Summary

Last month, the Department of Labor (the "DOL") released the following proposals and guidance relating to the investment duties of plan fiduciaries of retirement plans:

- An Information Letter permitting private equity investments in defined contribution plans, including 401(k) and 403(b) plans, to offer private equity investments that are part of target date funds and other professionally-managed, multi-asset class vehicles.

- A proposed rule to create a new prohibited transaction class exemption and a technical amendment that defines investment-advice fiduciaries.

- A proposed rule that would codify the DOL's position on how and when plan fiduciaries can consider environmental, social, and governance ("ESG") factors when selecting funds for a retirement plan's investment line-up.

Private Equity in Defined Contribution Plans

On June 3, 2020, the DOL issued an Information Letter in response to an inquiry regarding private equity investments in defined contribution plan portfolios. Although the letter addresses the permissibility of offering private equity investments as part of a professionally managed multi-asset class vehicle, it does not authorize offering private equity investments under a plan on a standalone basis. The letter reiterates that a plan fiduciary always has a duty to prudently select and monitor any designated investment alternatives in a defined contribution plan and offers the following factors that plan fiduciaries should consider when evaluating whether to include an asset allocation fund with a private equity component as an investment alternative:

- *Expected returns and diversifications*: The plan fiduciary should consider whether adding the particular asset allocation fund would allow plan participants to invest their accounts among more diversified investment options within an appropriate range of expected returns (net of fees) and diversification of risks over a multi-year period.

- *Governance*: The plan fiduciary should determine whether the asset allocation fund is overseen by investment professionals who have the capabilities, experience, and stability to manage an asset allocation fund that includes private equity investments effectively given the nature, size, and complexity of the private equity activity.

- *Liquidity and Valuation*: The plan fiduciary should analyze the percentage of the diversified investment option that will be invested in the private equity component, with the understanding that the percentage will affect the diversified investment option's costs, liquidity, potential complexity, and necessary disclosures. Additionally, the asset allocation fund should have a target allocation for private equity investments, with the remainder of the portfolio invested in publicly traded securities or other liquid investments with readily ascertainable market values, so that participants can take distributions and make direct exchanges among the plan's investment line-up consistent with the terms of the plan.

- *Plan Demographics*: The plan fiduciary should consider the demographics of the plan participants, including participant ages, normal retirement age, anticipated employee turnover, and contribution and withdrawal patterns, when analyzing a private equity investment option, and consider whether it aligns with the plan's characteristics and the needs of plan participants.

- *Participant Disclosures*: The fiduciary must ensure that participants are provided with disclosures that outline all risks involved with the private equity investments, as well as information that allows participants to make informed decisions regarding their investment options.

Plan sponsors interested in offering private equity investments should carefully consider the factors set forth above and continue analyzing all facts and circumstances in order to satisfy their fiduciary duty to prudently select and monitor investment options for their retirement plans.

Definition of an Investment Advice Fiduciary and Proposed New Prohibited Class Exemption

On June 29, 2020, the DOL announced it had taken the following actions regarding the regulation of investment advice: (i) submitted a technical amendment to the text of the Code of Federal Regulations to reflect a 2018 decision by the U.S. Court of Appeals for the 5th Circuit that vacated the DOL's 2016 fiduciary rule and the exemptions that accompanied that rule, and (ii) proposed a new prohibited class exemption that would be available for investment-advice fiduciaries.

The amendment essentially reinstated all previous regulatory text, including the 1975 five-part test for defining an investment-advice fiduciary. A person is an investment-advice fiduciary if he or she renders investment advice for a fee or other compensation, directly or indirectly, with respect to any moneys or other property of such plan or has authority or responsibility to do so. Under the five-part test, for advice to constitute "investment advice", a financial institution or investment professional must (1) render advice as to the value of securities or other property, or make recommendations as to the advisability of investing in, purchasing, or selling securities or other

property; (2) on a regular basis; (3) pursuant to a mutual agreement, arrangement, or understanding with the employee benefit plan, plan fiduciary, or IRA owner; (4) provide advice that will serve as a primary basis for investment decisions with respect to the plan or IRA assets; *and* (5) provide advice that is individualized and based on the particular needs of the plan or IRA.

Under the new proposed prohibited transaction class exemption, investment-advice fiduciaries would be permitted to receive compensation for providing fiduciary investment advice, including investment advice to roll over a participant's account in a retirement plan to an IRA, if certain criteria are satisfied. An investment-advice fiduciary relying on the proposed class exemption would have to provide advice in accordance with the "Impartial Conduct Standards," which means he or she must (i) provide advice in the best interest of the investor and not put any other interests ahead of that interest; (ii) charge only reasonable compensation; (iii) make no misleading statements; *and* (iv) seek to obtain the best execution of the investment transaction reasonably available under the circumstances. Under the new proposed class exemption, an investment-advice fiduciary would be required to document the specific reason that recommendations to roll over retirement plan assets from a plan to an IRA are in the best interest of the retirement investor.

ESG Factors in Selecting a Retirement Plan's Investment Line-Up

Over the last several years, the DOL has issued guidance regarding the extent to which retirement plan fiduciaries can consider ESG factors in selecting socially responsible investment funds for a retirement plan's investment line-up. As outlined in our prior EBU, the DOL's position on how much weight a plan fiduciary should give to ESG factors has swung back and forth slightly over the years, but the DOL has consistently emphasized the importance of an investment's financial performance. On June 23, 2020, the DOL issued a proposed rule that would codify a regulatory structure for the DOL's position regarding ESG factors and provide clear regulatory guideposts for plan fiduciaries. In proposing the rule, the DOL noted its concern that ESG investing may not be for the maximum benefit of the participants and that products are often marketed for reasons unrelated to financial performance of retirement plans, ultimately resulting in high fees and less emphasis on the financial benefits for the participants.

The proposed rule would require that a plan fiduciary take the following actions to ensure compliance with its duties of prudence and loyalty regarding ESG investing:

- 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.
- Prevent subordinating the interests of plan participants and beneficiaries in their retirement income and financial benefits to non-financial objectives.
- Consider other available investments with respect to diversification, liquidity and potential risk-return of the plan portfolio.
- Document the financial analysis and the potential impact on risk and return, if an ESG factor is selected.

- Use objective risk-return criteria in selecting and monitoring all investment alternatives and only use ESG factors as financial factors if they present economic risks or opportunities that qualified investment professionals would treat as material economic considerations under generally accepted investment theories.
- Only apply the "tie-breaker rule" in favor of ESG investing in the rare circumstance of choosing among economically indistinguishable investments.
- Do not add the ESG-oriented investment alternatives as a qualified default investment option ("QDIA") or as a component of a QDIA.

There is a 30-day comment period before the rule may be finalized. Plan sponsors should continue to monitor further developments and carefully document their rationale for any investment decisions that are made.

To discuss any of the information addressed in this Employee Benefits Update, or any other recently released DOL guidance, please contact any member of our Employee Benefits and Executive Compensation Group below.

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