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401(k) Plan Investments: ESG, Private Equity and Cryptocurrency

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Many employers desire to offer innovative investments in their 401(k) plans as a way to enhance the plan's value, attract talent and appeal to a younger workforce. But decisions regarding investment options are subject to ERISA's fiduciary standards. Non-traditional investments in a 401(k) plan, including environmental, social and governance ("ESG") funds, private equity ("PE"), and cryptocurrency, may pose special risks that participants may lack the experience and expertise to evaluate. (In fact, each of these types of investments are included in the SEC's 2022 Examination Priorities. [1]) This Legal Alert reviews the Department of Labor's (DOL) recent guidance regarding fiduciary issues with ESG, PE and cryptocurrency investments in 401(k) plans or other participant-directed plans, with key takeaways for fiduciaries of plans that offer them or who are considering making them available.

Fiduciary Standards. ERISA generally does not directly restrict the types of investments that can be held in a retirement plan.[2] Rather, ERISA requires fiduciaries to make prudent investment decisions (the "duty of prudence"), to make decisions solely in the interest of participants and their beneficiaries (the "duty of loyalty"), and to diversify assets so as to avoid large losses. [3] Prudent investment decisions require an "objective, thorough and analytical process that considers all relevant facts and circumstances."[4] As a result, fiduciaries must follow a prudent process for making investment decisions that are appropriate given the special characteristics of the type of investment under consideration.

Fiduciary considerations for a 401(k) plan or other plan with participant-directed investments are particularly sensitive given that participants' benefits depend on their investment return. In *Hughes v. Northwestern University*, 142 S.Ct. 737 (2022), the Supreme Court recently reaffirmed that proposition that fiduciaries are responsible for ensuring that each investment option offered is prudent for participants. (See our prior blog post.) Fiduciaries who fail to satisfy these duties may be responsible for any losses resulting to the plan.

ESG Factors. In November 2020, the DOL issued final regulations that provided a barrier for fiduciaries to make investment decisions that take into account ESG factors. Soon after taking office, President Biden issued an Executive Order directing the DOL to consider suspending, revising or rescinding the prior regulations and to identify actions it could take to "protect the life savings and pensions of United States workers and families from the threats of climate-related financial risk."[5] (See our prior blog post.)

After reviewing the 2020 regulations in light of this Executive Order, the DOL viewed these regulations as

having a "chilling effect" on ESG investments. Among other things, the 2020 regulations prohibit a 401(k) plan from selecting 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."[6] In issuing the 2020 regulations, the DOL conceded that it understood that "at least some ESG factors, at times, may also be pecuniary factors."[7] However, the DOL had previously warned that "[f]iduciaries must not too readily treat ESG factors as economically relevant to the particular investment choices at issue when making a decision."[8]

The 2020 regulations also reflected that non-pecuniary factors could be considered as a tie-breaker between otherwise equivalent investments, but suggested that an actual tie would be as rare as a "unicorn."[9] Accordingly, fiduciaries who take into account ESG factors – even when they are doing so because they have determined they are directly related to investment risk and return – could be expected to be subject to enhanced scrutiny and would need to be able to document why they determined ESG factors are material to an investment's risk and return.

In October 2021, the DOL issued proposed regulations with a new analysis for how fiduciaries can account for ESG factors in making investments. The 2021 proposed regulations reflect the DOL's new-found belief that fiduciary duties for evaluating investment options "not only allows but in many instances may require an evaluation of the economic effects of climate change on the particular investment or investment course of action."[10] The 2021 proposed regulations would eliminate the prohibition on selecting a QDIA based on ESG factors. The proposed regulations would also allow for investment options to be selected based on ESG factors not directly tied to investment risk and return, but only if the fiduciary does not expect reduced returns or greater risk than comparable investments. In this case, participant disclosures would need to include prominent displays of why the fund was selected.[11]

Generally, the 2021 proposed regulations reflect the DOL's intention to be neutral as to ESG factors. If a fiduciary finds that ESG factors are material to an investment's financial risk and return, "the fiduciary can and should consider it and act accordingly, as would be the case with respect to any material risk-return factor."[12]

But the proposed regulations specifically list climate change, corporate governance, and diversity and inclusion and labor relations as factors that a prudent fiduciary may determine are material to an investment decision.[13] Further, the DOL requested comments on whether a rebuttable presumption that climate change is a material investment risk should apply, and whether climate-change financial risk is already incorporated into the market pricing.[14] A presumption that climate change risk is material would potentially privilege climate change factors above most financial factors by establishing a presumption that they are material to investment risk and return. Such a presumption would not only be something that fiduciaries who considered climate change could rely on defensively, but the presumption could also potentially be used to suggest that fiduciaries who did not evaluate climate change factors for investments did not satisfy their duties to conduct a thorough process that took into account all material

factors.

If adopted without substantial changes, the 2021 proposed regulations could produce some uncertainty for fiduciaries in applying ESG factors. In this case, the DOL would be endorsing the consideration of ESG factors in evaluating investment options, and perhaps encouraging the consideration of climate-change factors. But fiduciaries would need to be mindful that the regulations could be rescinded or modified by a future administration. Further, courts may not be deferential to the DOL's position that a consideration of ESG factors is appropriate. For example, a court may find that advancing the employer's or fiduciaries' policy goals violated the fiduciaries' duty of loyalty.

Takeaways:

- The proposed regulations reflect that the DOL does not currently view ESG funds as inherently suspect. However, fiduciaries should be wary of relying on the DOL's position to apply ESG factors when they are not directly tied to the financial risk and return of an investment.
- Fiduciaries should always conduct an objective, thorough, analytical review of all material factors before making an investment decision.
    - Fiduciaries who take ESG factors into account should be careful to document that they have conducted a review that supports including ESG factors as material to an investment's risk and return.
    - If ESG factors that are not directly related to risk and return are considered as a "tie-breaker", fiduciaries should document that they have performed an analysis that concludes that they do not expect any reduction in return or increased risk with respect to the investment option compared to comparable investment options.

Private Equity. On June 3, 2020, the DOL issued an Information Letter that found that offering 401(k) plan investment options that include a PE component may be consistent with the fiduciary duties of ERISA.[15] The DOL stated that, in considering PE investments, fiduciaries should take into account differences in the nature of PE investments that "tend to involve more complex organizational structures and investment strategies, longer time horizons, and more complex, and typically higher fees." Fiduciaries should also consider whether a fund with a PE allocation is appropriate considering the plan's features and participant profile and whether sufficient information will be available for participants to make informed investment decisions. Further, fiduciaries offering a fund with a PE allocation should consider:

- Whether the fund offers participants the opportunity to investment among a more diversified investment options with a reasonable range of expected returns net of fees, with appropriate diversification over a multi-year period;
- Whether plan fiduciaries and their investment advisers have the necessary capability, experience

and stability to manage a fund with an asset allocation to PE; and

- Whether the fund appropriately limits the PE exposure given its unique investment characteristics and has adopted features for liquidity and valuation so that participants can take distributions or direct exchanges among investment options consistent with the plan's terms.

On December 21, 2021, the DOL issued a Supplemental Statement on its June 3, 2020 Information Letter cautioning fiduciaries from selecting PE investments.[16] Since issuing the Information Letter, the DOL recognized that the SEC had issued a Risk Alert pointing to compliance issues with PE investments it discovered in its examinations of investment advisers relating to conflicts of interest, fees and expenses, and policies and procedures regarding material non-public information.[17]

The Supplemental Statement noted that the Information Letter recited claims about the benefits of PE investments without presenting counter arguments and does not endorse or recommend offering funds with a PE component. For example, the Information Letter reflected that PE exposure may be appropriate for participants with longer time horizons, without appropriately taking into account that participants may need to liquidate their investments sooner than expected due to job changes. The Supplemental Statement also emphasized that PE investments in a 401(k) plan may involve securities, banking or other regulatory issues that fiduciaries and their advisers must have the expertise and experience to navigate. Further, the Supplemental Statement noted that the Information Letter was directed toward fiduciaries who had experience in evaluating PE investments for a defined benefit pension plan and cautioned against applying it outside of that context.

In *Anderson v. Intel Corporation Investment Policy Committee*, (N.D. Cal. Jan. 21, 2022), a federal district court generally supported the DOL's position that offering investment options with PE allocations is not inconsistent with the fiduciary duties of ERISA. *Anderson* considered claims that certain investment options, including the plan's target date funds, which included allocations to PE funds, hedge funds and other non-traditional investments that were imprudent. The complaint alleged that as a result of these non-traditional investments, the funds had worse performance and higher fees than comparable funds. The court dismissed these claims, finding that the complaint did not sufficiently plead plausible allegations to establish a breach of fiduciary duty, but granted leave to amend the complaint.

Takeaways:

- The DOL recognizes that PE may be a prudent part of an investment portfolio in very limited cases where the plan fiduciaries, with the assistance of their investment advisers, have the experience and expertise to evaluate special issues with PE allocations in a defined contribution plan, including fee structures, valuation issues, liquidity, and regulatory concerns.
- Fiduciaries who are considering offering investment options with PE allocations should also consider whether there are other available options that offer comparable benefits without these issues, and whether participants can be provided with sufficient information to make informed investment decisions.

Cryptocurrency. On March 10, 2022, the DOL issued a warning in Compliance Assistance Release No. 2022-01 ("Release"): 401(k) plans that hold digital assets like cryptocurrency should use extreme caution and prepare to be investigated.[18] The Release is the DOL's first written guidance on the appropriateness of cryptocurrency as an investment option in a 401(k) account.

In the Release, the DOL warns that at this early stage of the cryptocurrency market, plan fiduciaries should exercise "extreme care before they consider adding a cryptocurrency option to a 401(k) plan's investment menu for plan participants." This caution applies not only to direct investments in cryptocurrency, but to any "other products whose value is tied to cryptocurrency." Thus, any investment fund with an exposure to cryptocurrency could be questionable in the DOL's view.

The DOL listed five reasons for why it has serious concerns about offering investment options in cryptocurrency or related products in a 401(k) plan:

- Cryptocurrency assets are speculative and volatile investments;
- It is challenging for plan participants to make informed investment decisions and "to evaluate these assets and separate the facts from the hype;"
- There are custodial and recordkeeping concerns with holding cryptocurrency assets, such as losing private wallets and being more vulnerable to hackers and theft;
- Cryptocurrency valuations can be unreliable or inaccurate; and
- There is an evolving regulatory environment, including under securities and money laundering laws.

The DOL also said that it "expects to conduct an investigative program" aimed at plans that offer cryptocurrency and related products as investment options or that allow such investments through brokerage windows. The reference to brokerage windows is particularly surprising because the purpose of brokerage windows is to make investments available to participants that have not been evaluated and selected by the plan's fiduciaries. By suggesting that fiduciaries may have responsibility for particular investments offered through a brokerage window, the DOL may potentially undercut the purpose of brokerage windows.

Although the DOL stops short of completely prohibiting cryptocurrencies, the Release may discourage the use of cryptocurrency in 401(k) plans. The DOL said that it will question fiduciaries on how they "can square their actions with their duties of prudence and loyalty." This striking tone suggests that the DOL presumes any cryptocurrency-related investment option is imprudent and that the DOL believes there should be a high burden to justify any cryptocurrency-related investment options.

Takeaways:

- The DOL views cryptocurrency as a speculative and suspect investment option in 401(k) plans and cautions plan fiduciaries in using "extreme care" before offering cryptocurrency investment options in a 401(k) plan.

- Fiduciaries considering offering cryptocurrency investments or funds with cryptocurrency exposure should be able to document that they have followed a robust process that takes into account the DOL's concerns.
- Although the DOL has not issued guidance regarding any fiduciary duty to review specific options available under a brokerage window, fiduciaries should review that the design of the brokerage window, including the types of investment options offered, is appropriate for participants.

Conclusion.

Fiduciaries of 401(k) plans must be mindful of their fiduciary duties in making decisions regarding investment options under their plans. These duties require an objective, thorough and analytical process that considers all relevant facts and circumstances. Fiduciaries who are considering investment options that involve ESG, PE, or cryptocurrency investments, should take special care to ensure that their analysis reflects the special risks and issues that the DOL has raised with respect to these types of investments in its recent guidance.

Footnotes

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[1]U.S. Securities and Exchange Commission, 2022 Examination Priorities, available at: 2022 Examination Priorities Report (sec.gov).
[2]Section 408(m) of the Internal Revenue Code treats the acquisition of art, stamps, coins or other collectibles by an individual retirement account or individually directed account under a qualified retirement plan as a distribution, but this is not part of the fiduciary standards of ERISA.
[3]Section 404 of ERISA.
[4]Department of Labor, Information Letter 06-03-2020, available at https://www.dol.gov/agencies/ebsa/about-ebsa/our-activities/resource-center/information-letters/06-03-2020.
[5]Exec. Order 14030 of May 20, 2021, 86 Fed. Reg. 27967, available at https://www.whitehouse.gov/briefing-room/presidential-actions/2021/05/20/executive-order-on-climate-related-financial-risk/.
[6]85 Fed. Reg. 72846, 72865 (Nov. 13, 2020).
[7]85 Fed. Reg. at 72864.
[8]Field Assistance Bulletin No. 2018-01, available at https://www.dol.gov/agencies/ebsa/employers-and-advisers/guidance/field-assistance-bulletins/2018-01.
[9]85 Fed. Reg. at 72877.
[10]86 Fed. Reg. 57276 (Oct. 14, 2021).
[11]Prop. Reg. § 2550.404a-1(c)(3).
[12]86 Fed. Reg. at 57277.
[13]Prop. Reg. § 2550.404a-1(b)(4).
[14]86 Fed. Reg. at 57290.
[15]Department of Labor, Information Letter 06-03-2020, available at https://www.dol.gov/agencies

/ebsa/about-ebsa/our-activities/resource-center/information-letters/06-03-2020.

[16]U.S. Department of Labor Supplement Statement on Private Equity in Defined Contribution Plan Designated Investment Alternatives (Dec. 21, 2021), available at https://www.dol.gov/agencies/ebsa/about-ebsa/our-activities/resource-center/information-letters/06-03-2020-supplemental-statement.

[17]Office of Compliance Inspections and Examinations, Securities and Exchange Commission, Observations from Examinations of Investment Advisers Managing Private Funds (June 23, 2020), available at https://www.sec.gov/files/Private%20Fund%20Risk%20Alert_0.pdf.

[18]Compliance Assistance Release No. 2022-01, available at https://www.dol.gov/agencies/ebsa/employers-and-advisers/plan-administration-and-compliance/compliance-assistance-releases/2022-01. See also Exec. Order No. 14067 of Mar. 9, 2022, 87 Fed. Reg. 14143 (Mar. 14, 2022), available at https://www.whitehouse.gov/briefing-room/presidential-actions/2022/03/09/executive-order-on-ensuring-responsible-development-of-digital-assets/.