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DOL Final Regulation Eases Path for ERISA Fiduciaries to Consider ESG Factors When Selecting Investments

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In recent years, few topics within the U.S. Department of Labor's (the "DOL") purview have garnered as much interest as the potential consideration of environmental, social and governance ("ESG") factors by fiduciaries of plans subject to the U.S. Employee Retirement Income Security Act of 1974, as amended ("ERISA") when investing plan assets. A closely related issue is whether, and how, fiduciaries should vote proxies and exercise other shareholder rights on behalf of ERISA-covered plans.

On November 22, 2022, the Department of Labor issued a final regulation (the "Final Regulation") on these topics. The Final Regulation will generally be effective on January 30, 2023. As described further below, the Final Regulation (i) requires ERISA fiduciaries to make investment decisions based on risk-return factors, which the Final Regulation specifies can include ESG factors, (ii) allows ERISA fiduciaries to consider collateral ESG factors when deciding between investments that equally serve the plan's financial interests and (iii) clarifies that ERISA fiduciaries should generally exercise proxy voting and other shareholder rights.

Background

Since 1994, the DOL has issued a series of guidance addressing the extent to which ERISA fiduciaries may consider ESG factors. The DOL's guidance has generally been more permissive during Democratic administrations and more restrictive during Republican administrations. In 2020, at the end of the Trump administration, the DOL issued regulations on ESG and proxy voting (the "2020 Regulations") requiring ERISA fiduciaries to make investment decisions based solely on "pecuniary" factors and emphasizing that ERISA plans need not vote every proxy. In early 2021, the Biden administration issued a non-enforcement policy with respect to the 2020 Regulations, and shortly thereafter the DOL issued a new proposed regulation (the "Proposed Regulation") replacing the 2020 Regulations.

The Final Regulation — ESG Investments

The DOL stated that the Final Regulation is intended to retain the "core principle" running through prior iterations of its ESG guidance that "the duties of prudence and loyalty require ERISA plan fiduciaries to focus on relevant risk-return factors and not subordinate the interest of participants and beneficiaries (such as by sacrificing investment returns or taking on additional investment risk) to objectives unrelated to the provision of benefits under the plan." The Final Regulation also retains and expands the long-standing "tie breaker" test, which allows fiduciaries to consider collateral benefits when deciding between similar investments.

- *What Factors May an ERISA Fiduciary Consider?* The Final Regulation does not retain terminology requiring fiduciaries to consider only "pecuniary" factors, but instead requires that fiduciaries make investment decisions based on "factors that the fiduciary reasonably determines are relevant to a risk and return analysis." The Final Regulation explicitly states that this may include ESG factors. The importance of any given factor depends on the fiduciary's reasonable assessment of its impact on the risk-return analysis.
- *Is an ESG Analysis Always Required?* The Proposed Regulation stated that a risk-return analysis "may often require" an evaluation of ESG factors. The DOL removed this language in the Final Regulation to emphasize that ESG factors may not always be relevant to a risk-return analysis but simply should not be treated differently than other potentially relevant investment considerations.
- *Examples of Economic ESG Factors.* The text of the Proposed Regulation listed three specific examples of ESG considerations relevant to a risk-return analysis. The DOL omitted these examples in the Final Regulation to avoid the impression that the listed examples were favored over other investment considerations, and included additional examples of ESG considerations that may be relevant, including community impact, labor relations, and supply chain due diligence and management.
- *Tiebreaker Standard.* The Final Regulation permits collateral goals to serve as a tiebreaker between similar investment options if the investments "equally serve the plan's financial interests over the appropriate time horizon." Thus, collateral factors can break a "tie" between investments with different financial attributes. Unlike the 2020 Regulations, the Final Regulation does not limit the kinds of collateral benefits

that may be considered as a tiebreaker or impose specific documentation requirements on ERISA fiduciaries when using collateral factors as a tiebreaker. The Final Regulation also eliminates the Proposed Regulation's specific disclosure obligations to plan participants if a tiebreaker is used. However, the DOL suggested it may reevaluate the need for additional disclosure after reviewing the U.S. Securities and Exchange Commission's findings when it issues forthcoming final regulations on the topic of ESG disclosures.

- *QDIAs.* The 2020 Regulations prohibited the selection of a qualified default investment alternative ("QDIA") if its investment objectives, goals or principal investment strategies include the use of collateral ESG factors. The Final Regulation does not treat QDIAs differently than other investment options.
- *Consideration of Participant Preferences.* The Final Regulation adds a new provision stating that fiduciaries are permitted (but not required) to consider participants' preferences, including those related to ESG, when constructing a menu of investment options for a participant-directed plan. The DOL clarifies that this should not be interpreted to suggest that plan fiduciaries can choose imprudent investment options to satisfy these preferences. The DOL expressly declined to provide a methodology for how fiduciaries should solicit, monitor and weigh participants' varied preferences.

Proxy Voting and Shareholder Rights

The Final Regulation is also intended to retain the core principle that "the fiduciary duty to manage plan assets that are shares of stock includes the management of shareholder rights appurtenant to those shares, such as the right to vote proxies." Accordingly, the Final Regulation provides that a plan's proxies should generally be voted unless a fiduciary determines that doing so would not be in the plan's best interest (e.g., due to unusual costs or requirements). The Final Regulation eliminates the special recordkeeping and monitoring obligations that were imposed under the 2020 Regulations. While the Final Regulation continues to allow plan fiduciaries to establish policies on when to vote proxies if the policy is prudently designed to benefit plan participants and limit expenses, it removes the two "safe harbor" examples of such policies found in the 2020 Regulations.

When a pooled investment vehicle is subject to ERISA and several ERISA investors in the vehicle have investment policy statements that conflict with one another, the investment manager must attempt to reconcile the different policies and vote proxies in proportion with each relevant plan's interest in the pooled investment vehicle. Alternatively, an investment manager may require participating plans to review and approve of the investment manager's proxy voting policy prior to investing, in which case the investing fiduciary must ensure that the investment manager's policy is consistent with ERISA and the Final Regulation. The DOL declined to permit investment managers to obtain such approval through negative consent, and instead extended the applicability date for this provision for one year from publication of the Final Regulation. In addition, the DOL declined to explicitly extend such approval provisions to separately managed accounts ("SMAs"), but noted that ERISA would not preclude an investment manager from requiring plans to approve of its policies prior to agreeing to act as its investment manager.

Takeaways for Private Fund Sponsors

The 2020 Regulations initially had a chilling effect on some ERISA fiduciaries' willingness to invest in private funds that integrated consideration of ESG into their investment decision-making. However, this has become less frequent since the DOL's non-enforcement policy and the Proposed Regulation, particularly if the fund sponsor ties its consideration of ESG to expected financial performance. The Final Regulation should provide increased comfort to ERISA fiduciaries who may wish to invest in such funds. The DOL's removal of additional documentation and disclosure requirements when utilizing the tiebreaker provision could also increase ERISA plan investments into funds that consider collateral ESG goals, provided such an investment equally serves the plan's financial needs.

However, the last few months have seen a significant increase in so-called "anti-ESG" policies, legislation and legal opinions relating to governmental plans.[1] Such plans are not subject to ERISA, but state and local laws which may be modeled on or reference ERISA. The Final Regulation takes the position that an ERISA plan fiduciary's consideration of ESG factors is consistent with its fiduciary duties under ERISA when such factors are relevant to the risk-return profile of the investment. It is expected that the Final Regulation will to some extent influence laws governing governmental plans that are modeled on or incorporate ERISA, but it is also possible that they could lead certain states seeking to advance anti-ESG initiatives to expressly disavow the Final Regulation as persuasive authority. These developments will only complicate the landscape further for private fund sponsors seeking to attract a broad base of LPs that includes ESG-focused investors, ERISA plans and governmental plans that may be subject to anti-ESG investment restrictions.

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1. For example, Florida's State Board of Administration has issued a resolution providing that the evaluation of investment decisions "must be based only on pecuniary factors" that "do not include the consideration of the

furtherance of social, political, or ideological interests." Similarly, the Attorney General of Indiana has issued a legal opinion providing that the Indiana Public Retirement System's board violates its fiduciary duty when it invests or exercises voting rights to further ESG goals unrelated to the financial interest of the plan's beneficiaries.↩

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