Professional Perspective

# ERISA Fiduciary Considerations for ESG Investments

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# ERISA Fiduciary Considerations for ESG Investments

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This article describes certain aspects of the US Department of Labor (DOL) regulation regarding the effect of environmental, social and governance (ESG) factors in fiduciary investment and shareholder rights decisions for plans subject to Title I of the Employee Retirement Income Security Act of 1974 (ERISA). While the regulation does not change the statutory fiduciary standard for considering investments, it establishes the DOL's current view as to how the standard applies to making such decisions.

The appropriateness of including ESG factors in any investment decision has historically been subject to somewhat shifting guidance, often reflecting the views of the then current presidential administration. The role of such factors nonetheless continues to be the subject of debate. Recent legal actions and political proposals highlight the controversy.

## Regulation Background

The regulations titled "Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights" were published in the Federal Register on Dec. 1, 2022, and became effective on Jan. 30, 2023 (the "Regulation").The Regulation modifies, and in some cases reverses, regulations that were amended in November 2020 under the prior administration ("2020 Amendments").

Prior to the 2020 Amendments, guidance as to whether and how factors may be considered had consisted of sub-regulatory guidance including interpretive bulletins, advisory opinions and other statements, and non-regulatory guidance from the DOL over several decades. The DOL explained in the preamble to the Regulation, as well as in other statements, that it regarded the 2020 Amendments as potentially having a "chilling effect" on fiduciaries considering ESG factors in their investment decisions.

Consequently, the Regulation states explicitly that a "fiduciary may take into account ESG factors that are relevant to its financial analysis in making investment decisions," which in the self-directed plan context involves deciding the investment funds to be made available to participants.

## ERISA's Fiduciary Standard

ERISA Section 404(a) provides that in managing plan assets a fiduciary must act "solely in the interest of the participants and beneficiaries and …for the exclusive purpose of . . . providing benefits to participants and their beneficiaries." The Regulation, like the 2020 Amendments, confirms the DOL's longstanding position that a fiduciary's choice of that investments and investment courses of action must be based on factors that the fiduciary reasonably determines are relevant to an economic risk and return analysis, using appropriate investment horizons consistent with the plan's investment objectives and taking into account the funding policy of the plan established pursuant to ERISA.

Further, both the Regulation and the 2020 Amendments reconfirm prior DOL sub-regulatory guidance that a fiduciary may not use plan assets to promote policy causes at the expense of the financial interests of the plan's participants and beneficiaries, and that fiduciaries may not sacrifice the economic interests of plan participants—i.e., accept lower expected returns or take on greater risks—in order to promote objectives unrelated to the provision of benefits under the plan.

Although the Regulation, the 2020 Amendments, and prior guidance and caselaw do not conflict regarding the applicable fiduciary standard under ERISA, how the standard should apply to ESG considerations has been the subject of some ongoing controversy. Historically, guidance has tended to vary, to a large extent depending upon the political leanings of various administrations. Consequently, fiduciaries have had to deal with uncertainty as to whether they are acting appropriately.

 

## Considering ESG

ESG concerns like climate change have been the subject of much public discussion. The 2020 Amendments did not actually refer to ESG factors specifically, but rather required that fiduciaries focus solely upon "pecuniary"—i.e., economic—factors, which in any situation might, or might not, implicate ESG.

The 2020 Amendments stated that, with narrow exceptions, fiduciary investment decisions must be based solely upon an economic evaluation of all relevant factors determined by a fiduciary. Although the 2020 Amendments did not preclude consideration of economically relevant ESG factors, in the preamble to the 2020 Amendments, the DOL cautioned fiduciaries from too readily including ESG factors as economically material. However, the Regulation indicates that DOL regards the 2020 Amendments as potentially having a "chilling effect" on considering ESG.

The Regulation takes a different approach in pursuing the DOL's stated goal to be clear that ESG factors can be potentially relevant to a fiduciary's economic evaluation of investment alternatives. In developing the Regulation, the DOL noted its concern that the terminology, and presumably the tone, of the 2020 Amendments may have had the effect of putting a "thumb on the scale" against taking ESG factors into consideration.

The preamble to the Regulation again states that a fiduciary's obligation to evaluate the economic risk and return profile of investments and investment courses of action is unchanged, as is the obligation not to sacrifice returns to promote non-economic objectives. Although the fiduciary standard in the Regulation is unchanged from the 2020 Amendments—and prior guidance—the Regulation specifically states that a fiduciary may, but is not required to, conclude that ESG considerations are relevant to the financial risk and return evaluation of an investment decision, therefore, in the DOL's view, removing any doubt as to ESG's potential economic relevance.

This is a change from the proposed Regulation, which stated that a fiduciary "often may have to consider ESG." Whether ESG considerations are economically relevant, and how they are included in any analysis is ultimately a facts and circumstances determination by each fiduciary.

## Tiebreakers

An important exception to the general rule under both the Regulation and the 2020 Amendments is the so-called tiebreaker provision, which may in certain circumstance permit consideration of ESG factors even if a fiduciary does not consider them economically significant. Although some version of the tiebreaker provision has been included for many years in prior guidance, the Regulation and the 2020 Amendments take different approaches as to the circumstances where such considerations are permissible.

The 2020 Amendments permitted a fiduciary to consider non-pecuniary factors only when two investment alternatives are economically "indistinguishable." In the preamble to the 2020 Amendments the DOL noted its view that such situations are probably rare, and the DOL did not expect that tiebreaker provisions were likely to apply in most cases.

The Regulation revises the standard for considering non-economic factors, providing that non-economic factors, which may include ESG considerations, could be applied to situations where the fiduciary determines that two competing investments "serve the economic interests of the plan equally." The Regulation does not signal any particular view as to whether such situations are likely, and does not provide guidance as to when two alternatives may be viewed as equally serving the plan's investment objectives. However, a plain reading of the provision would appear to make invoking the tiebreaker more available than would be the case under the "indistinguishable" standard.

Notwithstanding the tiebreaker provisions, the preamble to the Regulation again states that these tiebreaker provisions in no way lessen the financial risk/return standard applicable to investment decisions generally—as described above. It is somewhat early as yet to have any significant indication as to whether fiduciaries will be willing generally to determine that the tiebreaker provisions apply, thereby permitting ESG considerations to be the determining factor in making an investment decision.

 

## Participant Preferences

There has been some question as to whether, and to what extent, fiduciaries can take participant investment requests for certain types of investments into account in designing an investment "menu" for a plan that permits participants to direct their investments, as is typical for 401(k) plans. While plan fiduciaries generally want to be responsive to participant desires as to where they can invest their retirement funds, the balance of being responsive with a fiduciary's obligation to invest prudently has caused some concern for fiduciaries.

In this regard, the Regulation provides that fiduciaries do not violate their duty of loyalty under ERISA solely because they take participants' preferences into account when constructing a menu of prudent investment options. However, as with all other investment decisions, whether to include any particular alternative is subject to the above-noted requirement that a fiduciary's decisions must be based upon an evaluation of the financial risk and return of such action.

## Proxy Voting & Shareholder Rights

The Regulation reiterates the DOL's position that the exercise of shareholder rights can be relevant to investment returns, and therefore fiduciary investment obligations include exercise of rights related to shareholding, including proxy voting. In general, the Regulation treats such decisions, including whether to vote shares, as subject to ERISA's general fiduciary standard of economic prudence that applies to other investment decisions.

Although the 2020 Amendments stated explicitly that fiduciaries are not required to vote every proxy, there is no requirement in the Regulation whether to vote, or not to vote, or take any other specific action, but rather a fiduciary must make its own decisions by prudently weighing the relevant financial risk/return factors, taking into account the costs involved. The preamble notes, and the Regulation provides, that a plan fiduciary is subject to the same prudence standard and monitoring obligations in hiring a proxy advisor as applies to hiring service providers generally. Fiduciaries of plans may adopt voting and exercise of shareholder rights policies for a plan, and must evaluate a manager's policies in considering any delegation of rights to the manager, including by investing in a pooled investment vehicle that is subject to ERISA.

The Regulation permits a manager to develop its own ERISA-compliant proxy voting policies for a pooled vehicle and require that a plan fiduciary, as part of its investment in a pooled vehicle, adopt the manager's policy with regard to the assets invested in the fund. Unless there is such an adoption of the manager's policy in a pooled fund, the manager would be required to follow each investing plan's policies—and to the extent possible reconcile conflicting policies—and vote each plan's proportionate holdings in accordance with such plan's policy, which would often be impractical.

## Recordkeeping

In a substantial difference from the 2020 Amendments, the Regulation does not add any recordkeeping requirements relating to fiduciary decisions implicating ESG factors. The 2020 Amendments had added a number of requirements that would have required fiduciaries to keep records of their decision-making in a number of instances.

The 2020 Amendments included recordkeeping safeguards to ensure that, by having to specifically describe their decisions, fiduciaries would be more likely to follow prudent practices in making decisions. The Regulation generally eliminated the special recordkeeping provisions of the 2020 Amendments to remove what the DOL regarded in the preamble as an unnecessary burden on fiduciaries.

Notwithstanding the removal of the special recordkeeping requirements, both the preamble to the 2020 Amendments and the Regulation make some note that prudent fiduciary practices often require appropriate records of the processes involved in making significant decisions generally.

 

## Differing Views

Not all interested parties believe that ESG factors are generally appropriate considerations for retirement investing. For example, although governmental plans are not subject to ERISA, and therefore the Regulation, a number of state and local governments have taken actions to restrict ESG investments in their plans.

Some recent developments also are challenging the appropriateness and future of the Regulation. A lawsuit was recently filed in the US District Court for the Northern District of Texas by 24 Republican-led states and a number of other plaintiffs, including entities involved in the energy industry. See *State of Utah et al v. Walsh et al*, Docket No. 2:23-cv-00016 (N.D. Tex. Jan 26, 2023). A separate suit was filed in the Eastern District of Wisconsin by several individuals who are participants in their employer retirement plan. See *Braun et al v. Walsh*, Docket No 2:23-cv-00234 (E.D. Wis. Feb 21, 2023). Both suits seek to overturn the Regulation on a number of bases including assertions that the Regulation permits fiduciaries to take into consideration non-economic factors, contrary to ERISA's standards, and that the implementation violates the Administrative Procedures Act.

Additionally, Congress narrowly passed resolutions to rescind the Regulation, which was vetoed by the President. Whether the lawsuits or congressional action, or any other potential efforts, will be ultimately successful is a matter of speculation. However, both actions highlight the continued disagreement among various constituents as to whether ESG factors are appropriate for retirement investment.

## Will Plan Fiduciaries Include ESG Factors?

The Regulation clearly permits fiduciaries to consider the economic effects of ESG factors in fiduciary investment and shareholder rights decisions. Many fiduciaries and plan participants have welcomed the Regulation as specifically permitting an important investment category. Whether an investment fiduciary believes there is sufficient basis to consider ESG or any other factors in any particular circumstance varies.

Considerations can become even more complicated since the precise scope of what qualifies as ESG is itself subject to much debate. Parties vary in their approach to what falls within the definition of ESG and as to how those factors should be evaluated. Ultimately each fiduciary must decide for themselves whether they believe any particular consideration falls into the definition of ESG and how the risk and return of such factors should be included in any fiduciary decision.

The further uncertainty highlighted by the recent lawsuits and political actions and the shifting guidance that has historically surrounded the ESG standard may cause some fiduciaries to be hesitant to include ESG considerations in their decisions. Since the Regulation does not require inclusion of ESG considerations, some fiduciaries may decide it is prudent to simply not include such factors generally in their decisions, while others might see such considerations as important for their investment decisions and including such factors as consistent with the Regulation.