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U.S. Department of Labor Issues Final ESG Investment Regulations

By Ron M. Pierce

Imagine that you are part of a 401(k) plan fiduciary committee tasked with deciding which investments will be available to participants. The sponsoring company's corporate citizenship promotes environmental, social, or governance (ESG) policies. The committee is debating whether adding a fund, consistent with the broader company ESG goals, is appropriate.

Your job, in large part, is to evaluate if this opportunity squares with your fiduciary duty to be a prudent decision maker and to be loyal to the best interests of plan participants. Are you putting the company interests in promoting ESG policies above participant interests? Is the fund an otherwise financially sound offering? Are you even allowed to consider ESG without risking liability for breaching your ERISA duties? What role, if any, should participant preferences play?

Under regulations issued in 2020 (the 2020 Rules), the U.S. Department of Labor (DOL) opined that considering ESG factors in making plan investment decisions was unlikely to ever be consistent with ERISA fiduciary duties. The underlying theme of these 2020 regulations was to "require plan fiduciaries to select investments and investment courses of action based solely on financial considerations relevant to the risk adjusted economic value of a particular investment or investment course of action."[1]

After a flood of opposition, a presidential election, and a tidal wave of public comments, the DOL has reevaluated its position and issued new final regulations in November 2022 (the 2022 Rules). The DOL felt that "the need for clarification comes from the chilling effect and other potential negative consequences caused by the [2020 Rules] with respect to the consideration of climate change and other ESG factors in connection with these activities."[2]

The 2022 Rules address three primary concepts that were particularly controversial under the 2020 Rules:

- When, if ever, is consideration of ESG factors consistent with the "application of ERISA's fiduciary duties of prudence and loyalty."[3]
- Whether the "pecuniary only" test outlined in the 2020 Rules is the proper standard; and
- Whether participant preferences for ESG focused investment alternatives are allowed to be a factor.

Some commentators believe that even the 2022 Rules' attempt to address these issues, still present a fiduciary predicament.[4] Remaining confusion "could result in participants' 401(k) plan accounts underperforming other reasonably available investments with the same risk profile, which likely would result in lawsuits against fiduciaries for breach of the duties of prudence and loyalty."[5]

Many articles have summarized the new rules. Although rule preambles do not set formal legal precedent, this article provides an analysis of the DOL's reasoning reflected in the preambles. Those conclusions in response to public comments provide helpful insights as fiduciaries continue to evaluate ESG investment opportunities.

How is ESG Defined?

The Wall Street Journal succinctly illustrated the increased pressure to factor in ESG: "It's hard to move in the world of investment without being bombarded by sales pitches for running money based on 'ESG.'"[6] But what is meant by ESG exactly (or at least as exactly as it can be defined)?

The Rules discuss how an elusive ESG definition is one of the primary difficulties with establishing useful guidance. "'ESG investing' resists precise definition." Rather, "[r]oughly speaking, it is an umbrella term that refers to an investment strategy that emphasizes a firm's governance structure or the environmental or social impacts of the firm's products or practices."[7]

Investment alternatives falling into this category often are referred to as "ESG themed funds," "impact funds," "sustainability funds," "social funds," "society-first funds," and so on."[8]

The 2022 Rules preamble provides the following examples of ESG "non-pecuniary" factors:

- Climate-related factors, such as a corporation's exposure to the real and potential economic effects of climate change;
- The impact on the company operations resulting from Government climate change mitigation regulations and policies;
- Corporate governance practices including board composition, executive compensation, transparency, and accountability;
- A corporation's avoidance of criminal liability;
- A company's compliance with labor, employment, environmental, tax, and other applicable laws;
- An organization's workforce diversity initiatives; and
- The entity's general labor relations and workforce practices.

What are a Fiduciary's General Prudence and Loyalty Investment Duties With Respect to ESG?

ERISA fiduciaries' duties include:

1. *Loyalty* - A fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries; and
2. *Prudence* - Fiduciaries must act "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in alike capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims."

Concerns regarding the threat of liability for breaching these duties, and the associated costs both in terms of money and effort, underly and inform all aspects of the following discussion.

2020 Rules

The 2020 rules are pretty straightforward:

> The [2020 Rules] require plan fiduciaries to select investments and investment courses of action based solely on financial considerations relevant to the risk adjusted economic value of a particular investment or investment course of action.[9]

Further, it is unlawful for a fiduciary to sacrifice return or accept additional risk to promote a public policy, political, or any other non-pecuniary goal.[10]

Finally, the DOL concluded that the regulatory guideposts established by the 2020 Rules provide objective criteria that "help fiduciaries understand how to comply with their duty of loyalty."[11]

2022 Rules

In contrast, the 2022 rules soundly reject the notion that loyalty and prudence duties prohibit the consideration of ESG factors.

Key concepts under the 2022 Rules are "appropriate consideration" and "acting accordingly."[12]

In stark contrast to the 2020 rules, the 2022 rules make clear that a fiduciary's appropriate consideration "may often require the evaluation of the economic effects of climate change and other environmental, social, or governance factors on the particular investment or investment course of action."[13]

Specifically, "appropriate consideration" rests on three clear principles:

1. A fiduciary's decision on a course of action "must be based on factors that the fiduciary reasonably determines are relevant to a risk and return analysis . . . taking into account the funding policy of the plan";
2. Based on the facts and circumstances, "risk and return factors may include the economic effects of climate change and other [ESG factors] on the particular investment or investment course of action"; and
3. The weight given to any factor by a fiduciary should appropriately reflect an assessment of its impact on risk and return.[14]

To illustrate "acting accordingly" with these principles, the DOL found the "scale" analogy advocated by some commentors useful. When balancing these competing interests, the 2020 Rules put a "thumb on the scale against ESG factors," even when they are relevant to a risk-return analysis. The 2022 Rules want to eliminate this chilling and discouraging effect on factors "that prudent investors otherwise would consider." While the 2022 Rules do not go so far as to mandate a "thumb on the scale in favor of ESG factors" they emphatically take the thumb off of the other side of that scale.[15]

In summary, any materially relevant factor (including ESG) may, consistent with the duties of prudence and loyalty, be considered when evaluating an investment.[16]

What is the "Pecuniary Only" Test?

2020 Rules

The 2020 Rules make clear, as a legal requirement, investment evaluation must be focused only on pecuniary factors (the "pecuniary only" concept). On one of the few points of agreement between the two sets of rules, "fiduciaries are not permitted to sacrifice investment return or take on additional investment risk to promote nonpecuniary benefits or any other nonpecuniary goals" when fulfilling their duties to participant retirement funds.[17]

2022 Rules

The 2022 Rules explicitly reject the "pecuniary only" principle and instead adopt an "any relevant factor" test. The DOL did so to address "concerns that the [pecuniary only] terminology causes confusion and a chilling effect to financially beneficial choices."[18] The preamble detailed that the "pecuniary only" test was "ambiguous or decidedly prohibitive" and, following a key theme of the 2022 Rules, operated as a "chilling effect" on the ability to "prudently consider climate change and other ESG factors that may be relevant to the risk-return analysis.[19]

The 2022 Rules articulate that any factor a plan fiduciary reasonably determines as relevant should be considered. Those relevant items expressly include "the economic effects of climate change and other environmental, social, or governance factors on the particular investment or investment course of action."[20]

Can Participant Preferences Influence Investment Selection?

The 2022 Rules added a concept not really covered in the 2020 Rules: the ability to consider participant preferences for ESG focused investments when designing an investment menu.

The DOL was persuaded by commentators' arguments asserting "that both increased participation and increased deferral rates follow from accommodating such preferences."[21] Failure to provide attractive investment choices, it was argued, may dampen the desire to save for retirement and would encourage participants to leave plans early.

The 2022 Rules do not mandate consideration of participants' preferences. Rather, "it leaves these questions to be decided by plan fiduciaries considering the facts and circumstances of their plan and participant population."[22]

Practical Application of the 2022 Rules

The 2022 Rules:

- Make clear that appropriate consideration of ESG can now confidently be incorporated into the investment selection process.
- Emphasize that fiduciaries must continue to focus first on relevant risk-return factors. ESG considerations should never result in sacrificed investment returns or increased investment risks.
- Serve as an excellent reminder that a plan's investment lineup must be reviewed under the guidance of a trusted investment advisor on a regular basis (at least quarterly).
- Encourage fiduciaries to document a deliberate decision-making process. Although the detailed documentation requirements of the 2020 Rules were eliminated by the 2022 Rules, properly detailed committee records remain essential to any successful defense. Minutes should detail why and how the investment option was selected, including a comprehensive investment analysis of each option considered.

Notes

1. 85 Fed. Reg. 72846 (2020 Rules), p. 72846.
2. https://www.dol.gov/newsroom/releases/ebsa/ebsa20221122 (2022 Rules), p. 73826.
3. 2022 Rules, p. 73826.
4. See a full treatment in Don Mazursky's excellent article at https://www.law360.com/articles/1558430?e_id=78666856-5f1a-4062-9ca7-0cf7dc6e294f&utm_source=engagement-alerts&utm_medium=email&utm_campaign=similar_articles.
5. Id.
6. See, e.g., James MacKintosh, A User's Guide to the ESG Confusion, Wall Street Journal (Nov. 12, 2019), www.wsj.com/articles/a-users-guide-to-theesg-confusion-11573563604.
7. 2020 Rules, p. 72857.
8. 2020 Rules, p. 72865.
9. 2020 Rules, p. 72846.
10. 2020 Rules, p. 72854, p. 72855.
11. 2020 Rules.
12. 2022 Rules, p. 73828.
13. 2022 Rules, p. 73830, fn 42.
14. 2022 Rules, p. 73831.
15. Id.
16. Id.
17. 2020 Regs 72858.
18. 2022 Rules, p. 73827.
19. 2022 Rules, p. 73834.
20. 2022 Rules, p. 73827.
21. 2022 Rules, p. 73841.
22. 2022 Rules, p. 73842.

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