Employee Benefits and Executive Compensation Alert
January 23, 2023

DOL Issues New Regulations on ESG Investing for ERISA Retirement Plans

On November 22, 2022, the U.S. Department of Labor (the "DOL") released new regulations (the "New Regulations") further clarifying the rules governing how retirement plan fiduciaries should approach plan investments under the Employee Retirement Income Security Act of 1974, as amended ("ERISA") and removing the prior regulations' barriers to considering environmental, social, and governance ("ESG") factors. The New Regulations will generally become effective on January 30, 2023, but certain provisions relating to certain proxy voting matters have a later effective date and will become effective December 1, 2023.

Background

Under ERISA's fiduciary duties of prudence and loyalty, retirement plan fiduciaries responsible for the investment of the plan's assets, investment fund selection, and other investment courses of action (including exercising shareholder rights) must do so focusing on risk and return factors of investment alternatives and not subordinate the interests of participants in their retirement income or financial benefits under the plan (*e.g.*, by sacrificing investment returns or taking on additional investment risk) to objectives unrelated to the provision of benefits under the plan.

Over the years and under different administrations, guidance (and, more recently, regulations) issued by the DOL has swung back and forth between taking a more permissive approach and a more restrictive one to considering ESG factors in retirement plan investments. Most recently, the prior administration issued regulations in late 2020 (the "prior 2020 regulations") that strongly discouraged the consideration of ESG factors in plan investments and imposed special requirements that needed to be met if ESG factors were part of the decision making process.

In the New Regulations, the DOL has now rolled back the restrictions on ESG factors under the prior 2020 regulations in an effort to avoid what the DOL perceived to be a "chilling effect" caused by those prior regulations with respect to the consideration of ESG factors by retirement plan fiduciaries in plan investments. We describe several of the noteworthy changes made by the New Regulations in the following sections.

General Standard for Considering ESG Factors

Under the New Regulations, plan fiduciary decisions on a particular investment course of action must be based on factors that a fiduciary reasonably determines are relevant to a risk and return analysis. This may (but is not required to) include consideration of ESG factors. Whether an ESG factor is relevant to a risk and return analysis will depend on the facts and circumstances of that particular investment. The New Regulations indicate that the weight given to any factor (including an ESG factor) by a fiduciary should appropriately reflect a reasonable assessment of its impact on the risk-return analysis.

The prior 2020 regulations had taken an approach where only "pecuniary" factors could be considered by plan fiduciaries – but that language has been removed in these New Regulations. The New Regulations also removed specific examples of ESG factors that were in the proposed version of these regulations to avoid any suggestion of a bias favoring ESG factors. Thus, the current approach under the New Regulations is a more neutral, facts and circumstances, approach where ESG factors may (or may not) be relevant in an investment course of action based on the reasonable determination of the plan fiduciary.

Qualified Default Investment Alternatives (QDIAs) / Investment Fund Line Up

Under the New Regulations, a plan may have as its QDIA an investment fund that contains ESG objectives in its investment strategy as long as the plan fiduciary otherwise determines it is prudent to select such fund, applying the same fiduciary standard as that which applies to any other investment fund under the plan. Thus, the New Regulations do away with the restrictions found in the prior 2020 regulations that prohibited adding or retaining any investment fund as a QDIA in a retirement plan if the investment fund included a non-pecuniary objective in its investment objectives or principal investment strategies.

In addition, the New Regulations clarify that if participants in a defined contribution retirement plan express a preference for having ESG-oriented investment fund options in their lineup to choose from, it would be permissible for a plan fiduciary to take that preference into consideration. More specifically, the New Regulations state that in a defined contribution plan with participant directed investments, a plan fiduciary does not breach ERISA's duty of loyalty solely because they take participants' preferences into account when constructing the menu of available investment options under the plan. The rationale offered by the DOL was that if giving consideration to participant preferences in selecting the fund lineup may lead to higher participation and higher deferral rates by participants, then it can be relevant to furthering the purposes of the plan.

Tiebreaker Test

The New Regulations also relaxed the standard under which ESG factors (or other collateral benefits) could be considered as a "tie breaker" when evaluating multiple investment options. Under the New Regulations if the plan fiduciary prudently concludes that competing investments "equally serve the financial interests of the plan over the appropriate time horizon", then in such situations, a plan fiduciary is not prohibited from selecting the investment, or investment course of action, based on collateral benefits other than investment returns (*i.e.*, using collateral benefits as a tie breaker).

Under the prior 2020 regulations, the "tie breaker" scenario was limited to those situations where the competing investments were "indistinguishable" based on pecuniary factors alone and imposed special documentation requirements for using collateral benefits as a "tie breaker" between the competing investments. This stricter standard no longer applies. In addition, the New Regulations eliminated special documentation and disclosure requirements relating to tiebreakers under the prior 2020 regulations, and instead the generally applicable ERISA duty to prudently document plan affairs will apply.

Proxy Voting / Shareholder Rights

The New Regulations clarify that exercising shareholder rights, such as voting proxies (including the determination of whether or not to exercise such rights), is part of the plan fiduciary's obligation to prudently and diligently manage plan assets. It is the DOL's view that the prudent management of shareholder rights can be important in enhancing the value of plan assets or protecting plan assets from risk.

In the DOL's view, the prior 2020 regulations contained provisions[1] that could have been interpreted either to suggest that plan fiduciaries can be indifferent to the exercise of shareholder rights, or to encourage the abstention of voting proxies as the normal course. Those provisions were eliminated in

[1] Those provisions from the prior 2020 regulations included "safe harbor" examples of proxy voting policies, specific monitoring obligations with respect to investment managers and proxy voting firms, and specific recordkeeping requirements.

the New Regulations. As noted above, certain provisions of the New Regulations applicable to proxy voting and the exercise of shareholder rights will be effective December 1, 2023.

Takeaways

The New Regulations generally allow plan fiduciaries greater latitude to take into account (if prudently determined by a plan fiduciary to be relevant to the risk-return analysis) the effects of ESG factors when selecting investments, or taking investment courses of action. The New Regulations (and their elimination of the special standards and provisions targeting ESG factors under the prior 2020 regulations) generally should ease investment decision making by ERISA plan fiduciaries both from a substantive and procedural perspective. However, more fundamentally, the DOL also reminds plan fiduciaries that they have always been (and continue to be) obligated to focus on relevant risk-return factors and not subordinate the interests of participants (*e.g.*, by sacrificing investment returns or taking on additional investment risk) to objectives unrelated to the provision of benefits to participants under the plan.

Douglas L. Tang	**212.336.2844**	**dtang@pbwt.com**
Jessica S. Carter	**212.336.2885**	**jcarter@pbwt.com**
Precious E. Nwankwo	**212.336.2236**	**pnwankwo@pbwt.com**

Patterson Belknap Webb & Tyler LLP
1133 Avenue of the Americas
New York, NY 10036–6710
212.336.2000
www.pbwt.com