December 2022

DOL Releases Final Regulation with Respect to ESG Investing

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Over the last few years, the U.S. Department of Labor's (the "DOL") guidance and rulemaking with respect to considering environmental, social, and governance ("ESG") factors in Employee Retirement Security Act of 1974, as amended ("ERISA")-covered plan investment decision making has ping-ponged with the changing administrations. Historically, Democrats have tended to promote ESG investing while Republicans have tried to rein it in. Following the Biden administration's launch of a government-wide effort to combat climate change, on November 22, 2022 the DOL released a final regulation (the "2022 ESG Rule"), which allows for more latitude in considering ESG factors when investing plan assets and backtracks on prior Trump-era restrictions in considering ESG factors.

By way of background, ERISA establishes fiduciary responsibility requirements for investment managers, trustees, and others who manage investments for ERISA-covered plans. ERISA fiduciaries have a duty of loyalty under ERISA to act "solely" in the interest of the plan participants and beneficiaries for the purpose of providing benefits under the plan and defraying the reasonable expenses of administering the plan. They are also required to act with "the care, skill, prudence, and diligence" that a prudent person would use in the conduct of an enterprise of like character and with like aims. The DOL has consistently provided that when considering ESG factors in plan investments, an ERISA fiduciary must satisfy these duties of loyalty and prudence.

The 2022 ESG Rule is the DOL's latest attempt to clarify the application of the duties of loyalty and prudence to selecting and managing investments in the context of considering ESG factors.

The 2022 ESG Rule replaces regulations promulgated in late 2020 at the end of the Trump administration (the "2020 ESG Rule") which essentially required ERISA fiduciaries to consider only those factors that have a material effect on risk and return when investing plan assets and permitted considering ESG factors only as a "tie-breaker" between investments in the rare occasion when investment return factors alone could not distinguish them.

In a press release that accompanied the 2022 ESG Rule, the DOL concluded that the 2020 ESG Rule discouraged and unnecessarily restrained the ability of ERISA fiduciaries to weigh ESG factors when choosing investments, even when those factors might benefit plan participants financially.

The hope among those who promote ESG investing is that the 2022 ESG Rule will encourage more use of ESG-focused investments for retirement savings. Bryan McGannon, managing director of U.S. SIF, the Forum for Sustainable and Responsible Investment, believes that "in the next few years, more and more plans will be offering sustainable options" as a result of the 2022 ESG Rule's recognition that ESG criteria should be treated like any other investment criteria when making investment decisions for ERISA-covered plans.

Additionally, the DOL's Assistant Secretary for Employee Benefits Security Lisa M. Gomez said that the 2022 ESG Rule "will make workers' retirement savings and pensions more resilient by removing needless barriers, and ending the chilling effect created by the prior administration on considering environmental, social and governance factors in investments. Climate change and other environmental, social and governance factors can be useful for plan investors as they make decisions about how to best grow and protect the retirement savings of America's workers."

The key takeaways from the 2022 ESG Rule are as follows:

1. While the 2022 ESG Rule retains the core principle that the duties of loyalty and prudence require ERISA fiduciaries to focus on relevant risk-return factors and not subordinate the interests of participants and beneficiaries to objectives unrelated to the provision of benefits under the plan, it clarifies that ERISA fiduciaries may consider ESG factors as one of the many criteria used by them to make investment decisions on behalf of plans and they may take into account ESG factors relevant to an investment's expected risk return and other financial factors.

   To be clear, the 2022 ESG Rule does not suggest or require that ERISA fiduciaries *must* consider ESG factors in investment decision making, but rather that ERISA fiduciaries *can* take into account ESG factors among the many factors considered when making an investment decision.

2. Unlike the 2020 ESG Rule, the 2022 ESG Rule does not require any special treatment for considering ESG factors and removes documentation requirements that commenters noted created unnecessary burdens.

3. For 401(k) plans and other participant-directed individual account plans, the 2022 ESG Rule removes the special rules for qualified default investment alternatives ("QDIAs") that applied under the 2020 ESG Rule (that a product was prohibited from being a QDIA under such plans if it included even one non-pecuniary objective). Under the 2022 ESG Rule, standards applied to QDIAs are no different from those applied to other investments. When selecting a QDIA, an ERISA fiduciary must, among other things, focus on relevant risk and return factors, which may take into account the impact of ESG factors on risk and return, and not subordinate the interests 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.

4. In response to a comment letter received by the DOL that accommodating participants' investment preferences may lead to greater participation in defined contribution plans and higher deferral rates, ultimately leading to greater retirement security, the 2022 ESG Rule adds a new provision that allows ERISA fiduciaries of participant-directed individual account plans to consider participant preferences when adding ESG investment options to the plan, so long as the other requirements under the 2022 ESG Rule are met.

> It is important to note that this provision only addresses the duty of loyalty, not the duty of prudence. Thus, an ERISA fiduciary may not honor participant preferences for investment options when constructing a menu of investment options for the plan unless the ERISA fiduciary believes the options are prudent.

The 2022 ESG Rule will become effective 60 days after publication in the *Final Register*. Also, as noted above, the political climate may change the DOL's guidance with respect to ESG investing. Some Republican members of Congress have already indicated their opposition to the 2022 ESG Rule and have expressed an intention to introduce legislation to amend ERISA to prohibit consideration of ESG factors. Additionally, some U.S. States, such as Florida and Texas, are proposing their own regulations to preclude the consideration of ESG factors in connection with investments by state retirement programs, so this is an area that requires continued monitoring.

As a best practice, we recommend that ERISA fiduciaries review their investment policies, or implement policies if none exist, for compliance with the 2022 ESG Rule and contact ERISA counsel for any further questions.

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If you have any questions concerning these developing issues, please do not hesitate to contact either of the following Paul Hastings New York lawyers:

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