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DOL Signals More Favorable View of ESG Funds in Retirement Plans

October 29, 2021

Last year the Department of Labor ("DOL") released a rule on Financial Factors in Selecting Plan Investments. This rule discouraged the use of climate change and environmental, social and governance ("ESG") factors when making investment decisions for ERISA-governed retirement plans.

Shortly after taking office in 2021, President Biden halted enforcement of the prior administration's rule, and ordered its review by the DOL. On October 14, 2021 the DOL released a proposed revision to the rule entitled "Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights" (the "Proposed Rule").

The Proposed Rule makes subtle changes to the prior guidance to make it somewhat easier for fiduciaries of retirement plans to offer ESG funds or otherwise invest in ESG companies. Despite these changes, investing in ESG investments in practice is not much different today than in the past.

Investment Prudence

The DOL has long held the position that in considering investments for a retirement plan, the fiduciary may only consider material factors relative to the risks and return associated with the investment. While the rhetoric surrounding ESG funds has certainly been toned down, this fundamental fiduciary requirement to focus on risk and return has not changed. The Proposed Rule explains that a fiduciary may consider the economic impact of ESG factors on an investment and may analyze how such factors impact the potential risk and return of the investment. However, at the same time, it instructs fiduciaries that the collateral benefit of investing in ESG funds can be considered only when the underlying investment "stands on its own" as a prudent investment from a financial point of view.

There is one potentially significant change in the Proposed Rule. Should a fiduciary conclude that competing investments equally serve the financial interests of the plan, they may use ESG collateral benefits to break the tie between those two investments. If the fiduciary uses ESG collateral benefits to break the tie, they must ***disclose*** those collateral benefits to participants. As of now, the DOL has not explained the timing or manner of these required disclosures. As a result, we expect many fiduciaries to steer clear of using ESG factors to break any ties until there is more guidance from the DOL.

The Proposed Rule also does away with the prior administration's prohibition on qualified designated investment alternatives with climate change or ESG goals or strategies. Given the continued need to

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focus solely on financial factors in selecting any investment, we do not expect this change to impact many fiduciaries' analysis of their plan's qualified default investment alternatives.

Proxy Voting

The Proposed Rule also revises prior guidance on proxy voting and may make it easier for those exercising shareholder rights to consider ESG factors when exercising those rights. Additionally, the Proposed Rule reverses prior proxy voting guidance and emphasizes that proxies should be voted unless the vote is not in the plan's best interest (e.g., there is significant cost associated with voting the proxy).

Comments Requested

Interested stakeholders have 60 days to send comments on the Proposed Rule. We expect further changes before the Proposed Rule is finalized.

Next Steps

A fiduciary is still required to consider the projected return of an investment decision relative to the plan's objectives. Should the Proposed Rule be finalized, however, a fiduciary could feel more comfortable considering climate change and ESG factors in considering an investment's return. A fiduciary should also be cognizant of the new disclosure requirement regarding tiebreaker situations where ESG collateral benefits are used to break a tie.

If you have questions regarding EGS funds, please contact a member of the Kutak Rock **Employee Benefits Practice Group**.

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