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Memorandum

Biden's First Veto: Understanding the Implications of the DOL's ESG Rule

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On March 20, 2023, President Joe Biden vetoed a Congressional resolution—the first of his presidency—that would have nullified the Department of Labor's ("**DOL**") newly-minted final rule concerning the consideration of environmental, social and governance ("**ESG**") factors in corporate retirement plans in the United States ("**ESG Rule**"). The ESG Rule addresses how a fiduciary under the Employee Retirement Income Security Act of 1974, as amended ("**ERISA**") may invest (and exercise shareholder rights with respect to) "plan assets" in accordance with ERISA's fiduciary duties when taking one or more ESG factors into account.[1] Absent a Congressional override of the veto, which appears highly unlikely at this stage,[2] the ESG Rule essentially remains in full force and effect.[3]

As described in more detail here, the ESG Rule (as now reinstated) simply reaffirmed the DOL's longstanding position: that an ERISA fiduciary must base its investment decisions on factors that the fiduciary reasonably determines are relevant to an investment's risk and return. This means that an ERISA fiduciary may not sacrifice investment returns, or take on additional risk, to further objectives unrelated to the *financial* benefits owed to participants and beneficiaries under the plan. The ESG Rule was adopted to overturn a regulation issued in 2020 under the Trump administration providing that ERISA fiduciary investment decisions should be made based on "pecuniary factors" only.[4] The ESG Rule also reiterates the DOL's position that fiduciaries can and should consider any and all factors that are relevant to the risk/return analysis of a potential investment. These factors *may* include climate change and other ESG-related issues under certain circumstances.[5] The ESG Rule under no

[1] Many fund sponsors structure their funds to avoid holding ERISA "plan assets," such as by relying on the "venture capital operating company" and "real estate operating company" exceptions or by satisfying the "25% Test." In those instances, ERISA is not applicable to the management of those funds and the fund manager's compliance with the DOL's ESG rule is not required.

[2] At this stage, it appears exceedingly unlikely that Congress will achieve the 2/3 majority in both the Senate and the House necessary to override the veto. The 216-204 House vote was mostly along party lines, with only one Democrat voting in favor of the resolution; the 50-46 Senate vote included two votes by Democrats.

[3] Key provisions of the ESG Rule went into effect on Jan. 30, 2023, but certain provisions involving proxy voting policies take effect on Dec. 1, 2023.

[4] The 2020 rule defined "pecuniary factor" as a factor the fiduciary prudently determined is expected to have a material effect on the risk/return of an investment based on appropriate investment horizons consistent with the plan's investment objectives and the funding policy. The DOL's choice of "pecuniary" as the 2020 rule's standard appears to be a nod to a unanimous 2014 U.S. Supreme Court decision (*Fifth Third Bancorp. v. Dudenhoeffer*, 573 U.S. 409 (2014)), which held that ERISA's duty of prudence is focused on "financial benefits (such as retirement income)" and not "nonpecuniary goals set out in an ERISA plan…."

[5] This includes the *Financial Factors in Selecting Plan Investments* rule issued by the DOL under the Trump administration, which established that an ERISA fiduciary's evaluation of an investment must, except in rare scenarios, be based only on pecuniary factors. *See* 85 Fed. Reg. 72846, 72848 (Nov. 13, 2020) ("[t]he [Financial Factors] rule recognizes that there are instances where one or more environmental, social, or governance factors will present an economic business risk or opportunity that corporate officers, directors, and qualified investment professionals would appropriately treat as material economic

circumstances requires a plan fiduciary to consider ESG-related issues if they are not relevant to that risk/return analysis.

To reiterate, the ESG Rule:

- **Does** require an ERISA fiduciary's investment decision to be based on factors that the fiduciary reasonably determines are relevant to the risk/return analysis, which may include the economic effects of climate change and other ESG factors on the proposed investment.
- **Does not** alter the longstanding requirement for fiduciaries to consider all relevant factors in the risk/return analysis.
- **Does not** require the incorporation of ESG factors into that analysis where not relevant to the risk/return analysis.

Given that the DOL's ESG Rule does not encourage, much less compel, a fiduciary's consideration of ESG factors, why did a Congressional resolution overturning it pass both the House and the Senate? The Congressional action was prompted at least in part by a letter from 27 Republican state Attorneys General, which asserted that the ESG Rule "contradicts the plain language of ERISA" (among other claims), and asked Congress to act. It is part of a larger campaign unfolding at both the state and federal levels taking aim at ESG investing via actions involving regulators (including the Securities and Exchange Commission and the Comptroller of the Currency) and the private sector (including banks and asset managers), as well as Congress and other legislatures. Ultimately, the resolution underscores the politicized nature of ESG (both for and against) in the context of ERISA.[6] We expect this to remain a relatively fluid situation for the foreseeable future.

Further adding to the uncertainty over the status of the DOL's ESG Rule is the filing of multiple lawsuits seeking to enjoin its enforcement. Earlier this year, for example, 25 states sued the DOL in the Northern District of Texas, a jurisdiction that may be favorable to the plaintiffs, alleging, among other things, violations of the Administrative Procedures Act and the "major questions" doctrine. We will continue to monitor these lawsuits.

As the landscape continues to shift, key principles related to the ESG Rule that should remain top of mind include:

- For ERISA fiduciaries: consider revisiting agreements and related policies and procedures, including any proxy voting policies, to determine whether any amendments are appropriate.
- For fund sponsors with ESG strategies: consider how the rule's permissibility of ESG strategies within the default investment option in a 401(k) plan may allow for new opportunities to access ERISA capital.
- For investment managers that service governmental plans: consider the efforts undertaken by various state legislatures related to ESG to ensure continuing compliance with the plan's laws, rules and policies.

considerations under generally accepted investment theories.")

[6] All states that signed the letter have either implemented laws or are considering bills that take aim at ESG investing.

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