

Insights for fiduciaries

Retirement plans and sustainable investing—guidance for plan fiduciaries

Retirement account arrangements sponsored by private US employers are subject to regulation under the US Employee Retirement Income Security Act of 1974, as amended (“ERISA”). ERISA imposes strict rules on how retirement savings can be invested in order to ensure that those assets are managed prudently and are not subject to conflicts of interest. The strict nature of these rules has led to questions as to whether and, if so, under what conditions retirement savings held in ERISA plans can be invested using sustainable—or Environmental, Social and Governance (“ESG”)—investment strategies.¹

These questions have been addressed through interpretations of ERISA’s fiduciary responsibility rules by the US Department of Labor (“DOL”), in the form of regulations setting forth a road map by which ERISA-regulated fiduciaries may incorporate certain ESG factors and strategies within their investment decision-making process (the “ESG Rule”).² The ESG Rule is grounded in long-standing ERISA principles, interpreting ERISA’s fiduciary duties of prudence and loyalty in a way that allows for the consideration of ESG factors within the framework of the DOL’s general guidance on ERISA’s prudence and loyalty standards.

Importantly, the ESG Rule frames ESG factors as simply part of the universe of factors that a fiduciary could consider if they are financially relevant to a plan’s investment. In some instances, the ESG Rule would allow for ESG and certain other factors to be considered even if not, in themselves, financially relevant (as detailed below in the discussion of participant preference and collateral benefits). Despite our use of the term “ESG Rule” to describe it, however, the ESG Rule does not single out ESG factors for special treatment—considering ESG factors is neither required, nor subject to unique justification or documentation conditions.

I. ESG investing

What is referred to today as “ESG investing” has been described by a number of different terms throughout its history, including “socially responsible investing,” “sustainable investing” and “values-based investing” (not always referring to exactly the same thing, but describing similar general concepts).

Roughly speaking, ESG investing encompasses some or all of the following as part of an investment decision-making process:

- The environmental impact or exposure of a firm’s products or practices, such as with regard to the impact of mining, production or use of fossil fuels or exposure to business locations or activities in areas subject to climate risks;
- The social impact of a firm’s products or services, such as with regard to workforce practices, the firm’s labor relations or effect on local communities; and
- A firm’s corporate governance structure, such as with regard to executive leadership, executive pay and compliance.

There is no fixed legal definition, so that what is considered as ESG investing may vary depending on the context or the particular regulatory regime.

Many investment professionals (even those at non-ESG-specific investment shops) use ESG-based strategies to consider the financial impact that certain ESG type factors may have on corporate performance. There are competing studies on the financial benefits of ESG investment strategies and the debate over the financial relevance of certain ESG factors to corporate performance is ongoing. Ultimately, the question of whether ESG investing is an objectively better investment approach or plays an appropriate role in a diversified investment portfolio is one for investment professionals. This paper focuses instead on the legal standard that applies to the decision to take considerations viewed by the market as ESG factors into account as part of a fiduciary’s prudent investment process.

II. DOL guidance

ERISA requires plan fiduciaries to act prudently and solely in the interest of a plan and its participants and beneficiaries in making investment decisions. As such, a plan’s investment fiduciaries are, in the first instance, required to consider only those factors relevant to the prudence of the particular investment decision, including the degree of risk, maximization of returns, diversification and furtherance of a plan’s funding

objectives. On this basis, the DOL's consistent view over the years has been that ERISA's fiduciary duty rules do not permit fiduciaries to sacrifice the economic interests of a plan to promote "collateral" goals.

Background to current DOL guidance. The ESG Rule is the most recent volley in a decades-long regulatory back-and-forth with respect to the use of non-financial factors in making investment decisions for ERISA plans and successive DOL administrations' evolving interpretations. The general trend is that Democratic administrations issue guidance interpreting ERISA's duties of loyalty and prudence as more favorable toward considering values-based investing, while Republican administrations interpret those same duties as limiting values-based investing.

ESG is a "may" but not a "must." The current ESG Rule, the product of a Democratic administration, does not go so far as to mandate that ERISA fiduciaries must consider ESG factors. Rather, ESG factors can take their place among the range of financially relevant factors that fiduciaries may consider when making investment decisions on behalf of the plan.

Participant preference may be considered. Under the ESG Rule, a fiduciary of a participant-directed individual account plan does not violate its duty of loyalty simply by taking participant preferences for certain types of investment funds into account when evaluating plan investment options, as long as it does so in a manner consistent with the requirements of the duties of loyalty and prudence.

This provision appears to be driven by comments and research regarding the impact of participant preference related to defined contribution plans. The DOL's explanation suggests that accommodating participant preference could increase participation and deferral rates, citing studies indicating that participants might "increase their overall contribution rate if they were offered an ESG option." The DOL specifically emphasizes, however, that participant preference comes second to fiduciary duties, so that a fiduciary cannot add an imprudent option just because participants would prefer it.

Fiduciaries may, in certain circumstances, consider non-financial "collateral" benefits. For decades, DOL guidance on values-based investing has included what has been referred to as a "tie-breaker test," whereby a fiduciary could consider collateral, or non-financial, factors in order to "break the tie" between investments that are otherwise identical from a risk-return perspective.

As it is now presented, the ESG Rule's formulation of this test provides some additional flexibility by permitting reliance on collateral benefits to "break the tie" in instances where "competing investments . . . equally serve the financial interests of the plan."

Importantly, the DOL's discussion of the tie-breaker test and collateral benefits in general de-emphasizes ESG specifically and underscores that the ESG Rule is more in the nature of a principles-based regulation that does not solely deal with ESG factors. The preamble to the ESG Rule lists examples of collateral benefits that a fiduciary might consider to break a tie, such as stimulating union jobs to in turn increase contributions to a multiemployer plan and investing in the geographic region where plan participants live and work, none of which necessarily include ESG—which is consistent with viewing ESG factors as potentially qualifying as financial considerations, in which case they would not need to be treated as "collateral" benefits. The preamble also emphasizes that plan fiduciaries are not required to consider collateral benefits in making investment choices, i.e., relying on the tie-breaker test is optional.

Fiduciaries have a duty to vote proxies and exercise shareholder rights, both in regard to ESG issues and non-ESG issues. The ESG Rule emphasizes a long-standing principle in DOL guidance that a fiduciary's duty to manage plan assets includes the appropriate exercise of shareholder rights related to those assets, including the right to vote proxies. According to the rule, fiduciaries should vote these proxies unless they have a good reason not to (for example, if it would be too costly).

In keeping with the theme of "regulatory neutrality," this section of the regulation is not specific to ESG. It simply encourages fiduciaries to vote proxies on issues that are financially relevant to the investment, ESG or not.

III. General considerations for plan fiduciaries

Because of the pattern of each new administration issuing its own variation of ESG-type investing guidance (and, more recently, litigation on the issue and the possibility of legislation), plan fiduciaries have been concerned about possible uncertainties and risks in relying on whatever was the then-current DOL position. However, as noted above and in the ESG Rule, one thing never changes—the fundamental principle that ERISA plan fiduciaries should make investment decisions based foremost on prudent investment considerations, and should not sacrifice investment return or take on additional investment risk in order to promote "collateral" or "non-financial" objectives such as social policy goals.

The ESG Rule follows this fundamental principle by not permitting plan fiduciaries to sacrifice investment return or take on additional investment risk to promote "benefits or goals unrelated to the interests of the participants and beneficiaries in their retirement income or financial benefits under the plan." Thus, to the extent the consideration of ESG factors is part of a prudent investment analysis, such consideration can be viewed as consistent with ERISA's fiduciary standards.

This leaves plan fiduciaries, with the aid of their investment consultants and other professionals, to draw their own conclusions as to how they understand particular ESG considerations to factor into their prudent investment analysis and to act accordingly.

As a general matter, fiduciaries are well advised to document that they followed a prudent investment process in making investment decisions that take into account ESG considerations, such as in the selection of funds to include in a plan's investment lineup, to create a contemporaneous record of this process in the event of a future challenge. This focus on documentation is especially worth considering in an area that may, in light of the evolving standards and increased political attention, receive scrutiny going forward.

IV. Summary of key points

To summarize the key points of this paper, the current state of the DOL guidance on ESG investing provides as follows:

- ESG factors may be considered as part of a fiduciary's investment process if the specific factors being considered are financially relevant to the investment decision.
 - Fiduciaries may consider referencing industry or academic literature and/or engaging consultants or other professionals to aid in determining and documenting the financial relevance of specific ESG factors.
- Fiduciaries may consider participant preferences when making decisions regarding investment options on behalf of a participant-directed plan, as long as the decision is otherwise prudent.
 - Fiduciaries looking to rely on this provision should determine and document what participant preferences are and document the process by which those preferences are considered as part of the decision-making process.
- Fiduciaries may consider the collateral benefits of a certain investment course of action if two (or more) competing investments equally serve the financial interests of the plan.
 - Fiduciaries relying on this approach should consider documenting the basis for any "tie-breaker" decision, just as any fiduciary action on behalf of the plan should best be documented to protect against the risk of a future challenge.
 - Fiduciaries may consider engaging consultants or other professionals to help in determining that two or more competing investment courses of action would truly "equally serve" the financial interests of a plan.

¹ While the title of this paper uses the term “sustainable investing,” much of the guidance analyzed in this paper uses the term “ESG investing” to describe the same type of investment process.

² While the DOL guidance is applicable by its terms only to employee benefit plans that are governed by ERISA, it is also may be viewed as an appropriate standard for fiduciaries of non-ERISA plans, such as state and local governmental plans, absent any plan-specific laws or regulations providing otherwise. Governmental plans in particular often operate under laws similar to ERISA and may incorporate ERISA fiduciary standards by reference into their investment management or consulting agreements. That said, several states have adopted special rules dealing with ESG investing that differ from ERISA standards.

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