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# Wagner Law Group: Climate Funds, ERISA May Co-Exist, With Prudence

A fiduciary can use climate funds, as long as they 'equally serve' the financial interests of participants.

*Reported by* PAUL MULHOLLAND

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The Wagner Law Group published a legal opinion letter outlining how and when fiduciaries for defined contribution plans can consider "climate-aligned" funds in investment menus. The letter was written on behalf of Impact Experience, a nonprofit and advocate for sustainable investing.

According to the letter, the legal considerations for climate-aligned funds essentially come down to how a fund considers climate-related factors in its risk-return analysis.

According to the ERISA attorneys, if the fund subordinates financial returns to collateral benefits, such as combatting climate change or lowering greenhouse gas emissions, then its inclusion in an investment menu is not permissible under ERISA: "In no event may a DC Plan fiduciary subordinate the financial interests of plan participants to other objectives."

If the fund does not subordinate financial interests to collateral interests, however, then climate-related factors may be added, provided that their inclusion is otherwise consistent with the duties of loyalty and prudence to the plan.

"A DC Plan fiduciary is permitted to select a menu option for its collateral benefits, only if such selection is made from competing menu alternatives where the DC Plan fiduciary has prudently concluded that such menu option and its competing alternatives would equally serve the financial interests of plan participant," the letter stated.

The language "equally serve" mirrors the language found in the Department of Labor's final rule on environmental, social and governance as it relates to ERISA, finalized in November 2022.

The DOL's outlines the "tiebreaker" test, in which an ERISA fiduciary decides between two investments, one with a collateral benefit and one without. According to DOL guidance, the fund with the collateral benefit may be chosen if both would "equally serve the financial interests of the plan over the appropriate time horizon. In such cases, the fiduciary is not prohibited from selecting the investment, or investment course of action, based on collateral benefits other than investment returns."

Though this rule is facing two legal challenges, it is the governing rule.

**Different Types of Climate Funds**

Wagner outlined three categories of climate-aligned funds: climate integration, climate focused and climate impact.

Climate integration funds make adjustments for climate risks and opportunities and typically do not have hard thresholds or "screening" that would categorically exclude certain climate-related metrics. These funds can be considered on their own merits because they do not subordinate financial returns to collateral benefits, since they integrate climate risk as a financial return criterion.

Climate-focused funds use climate risks as a "significant factor" in selection. They may also feature positive or negative screens that include or exclude securities which meet or fail to meet particular climate-related thresholds. Similar to integration funds, focused funds can be considered on their merits as long as "the fund is not applying an investment screen in the pursuit of collateral or other non-investment benefits to the detriment of fund investors."

When it comes to focused funds, the consideration of alternatives is key. Wagner recommended that a fiduciary "investigate competing menu alternatives that have conventional investment strategies and that are otherwise similar to the Climate Focused Fund."

Wagner noted that ERISA does not, per se, forbid screens, and likens focused funds to specialty funds, or funds that focus on a specific sector and are often found in investment menus: "Specialty Funds are routinely considered as menu options for DC Plans, and the relevant screening feature is simply evaluated by plan fiduciaries as an integral component of the specialty fund's investment strategy. Analogously, it should be permissible to include prudently selected Climate Focused Funds in DC Plan menus."

Lastly, Wagner considered impact funds. As a best practice, Wagner recommends not adding impact funds at all to an investment menu, because they subordinate financial returns to climate goals and are willing to lower returns to that end if necessary: "As a suggested 'best' practice, we would recommend that Firms in their capacity as DC Plan fiduciaries exclude Climate Impact Funds."

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**Tags** climate change risk, DOL, EBSA, ERISA, ERISA fiduciary duty, ESG

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