**Critical Analysis of the Department of Labor's Attempt to De-Legitimize ESG for ERISA Fiduciaries:**

**January 26, 2021**

**By: Jamison A. Friedland**

**Abstract:**

In November 2020, the US SIF Foundation reported approximately $17.1 trillion (or 33%) of all U.S assets under professional management are considered sustainable investing assets, an increase of 42% since 2018. With the growth of ESG investing, regulatory bodies have sought to provide guidance on how ESG metrics should be considered by investors and professional money managers. In 2020, the DOL adopted a regulation intended to strictly limit fiduciaries use of ESG metrics in their investment decisions.

In this critique, we look at how the DOL's finalization of their regulation "walks back" the most direct attacks on ESG metric considerations but still contains fundamental flaws. The final regulation conflicts with other regulations, makes faulty assumptions on ESG materiality and costs (partly due to lack of basic due diligence), and disregards another regulatory agency's historical jurisdiction. These findings suggest that under the new President Biden administration, the DOL will likely make fundamental changes to clarify how fiduciaries can use ESG metrics and still maintain their ERISA mandate of managing for the client's best interests.

On October 30th, 2020, The United States Department of Labor (DOL) finalized regulations (Final Regulation) proposed on June 30th, 2020 (Proposed Regulation) regarding the "investment duties" regulation under Title I of the Employee Retirement Income Security Act of 1974 (ERISA).[1] Both the Proposed Regulation and the Final Regulation targeted how ERISA fiduciaries considered Environmental, Social, and Governance (ESG) metrics for their investment decisions and recommendations. As noted by a commentator, the Proposed Regulation was correctly perceived as "a focused attack on one type of investment or one investment philosophy… (and) Congress did not write that law to put the DOL in the business of picking specific winners and losers for retirement plan investments".[2]

Given the overwhelmingly negative reactions from all sectors of interested parties to the Proposed Regulation, in the Final Regulation the DOL slightly amended their stance on ESG but noted with considerable concern that "the growing emphasis on ESG investing may prompt ERISA plan fiduciaries to make investment decisions for purposes distinct from providing benefits to participants and beneficiaries". However, the DOL abandoned its attempt to make ESG a per-se negative investment, noting that ESG is a broad concept and "does not have a uniform definition" and therefore is "not clear or helpful lexicon for regulatory standard".[3] Specifically, the Final Regulation has no mention of ESG metrics, opening the door, under clearly defined circumstances, for a fiduciary to add prudently selected ESG oriented investments as a plan option without violating ERISA. This "walk-back" by the DOL is likely a result of the abundance of negative comments and the probability that the initial Proposed Regulation could be successfully challenged by court review for the following reasons.

The Proposed Regulation was intended to provide definite guidance to ERISA fiduciaries regarding ESG investing that would have made it almost impossible to consider ESG metrics in their investment considerations.[4] The Proposed Regulation's rationale was that it was a clarification of the established principal that ERISA investments must be based solely on "pecuniary" considerations and that ESG metrics were "non-pecuniary" and therefore a prohibited consideration. While it is possible that the motives of the DOL were solely based on providing clarity, the Proposed Regulation still contained several fundamental flaws. First, it ignored an Executive Order of the Trump Administration on creating new regulations. Second, it was based on disingenuous assumptions regarding fiduciary alignment and ESG performance. And finally, the DOL overstepped its authority as it is not the correct government agency to provide commentary on the accuracy of ESG disclosure.

---

[1] https://www.federalregister.gov/documents/2020/06/30/2020-13705/financial-factors-in-selecting-plan-investments

2 https://www.planadviser.com/exclusives/dol-found-esg-middle-ground/

3 https://www.groom.com/resources/dol-shifts-focus-from-esg-to-pecuniary-factors-in-final-rule/

[4] https://www.federalregister.gov/documents/2020/06/30/2020-13705/financial-factors-in-selecting-plan-investments

A major tenet of the Republican Party is that government intervention should be as minimal as necessary to be effective. This carried through to the 2016 platform where then Presidential Candidate Trump pushed for widespread deregulation, while calling for a moratorium on new regulations and a review process to eliminate current unnecessary regulations.[5] On January 30th, 2017, President Trump signed Executive Order 13771: Reducing Regulation and Controlling Regulatory Costs (EO 13771). Section 1 states that "for every one new regulation issued, at least two prior regulations be identified for elimination, and that the cost of planned regulations be prudently managed and controlled."[6] This became known as the "one in-two out" provision of (EO 13771). The administration took (EO 13771) so aggressively that in the following six months, they eliminated 16 rules for every new one implemented and had targeted 860 regulations.[7] Deregulation in the financial industry was an early target when on February 3rd, 2017, President Trump announced plans to reconsider regulations implemented by the Obama Administration in response to the 2008 financial crisis.[8] For example, a piece of the Dodd-Frank Act was targeted through a memorandum that reverses the fiduciary rule, the policy that requires brokers to act in a clients' best financial interests. This memo directed the DOL to analyze whether this fiduciary rule, "adversely affects" investors access to financial advice. The proposed removal of the fiduciary rule was meant to reduce complexities for fiduciaries and ultimately improve the investor experience. Meanwhile, the Proposed Regulation is that it offsets this desired simplicity by making the utilization of ESG metrics more complicated for fiduciaries and ultimately "adversely affecting" investors.[9]

Under ERISA, the DOL has authority for rules and regulations that govern private industry retirement and health plans. Section 404 of ERISA, in part, requires that ERISA Plan fiduciaries to act prudently to minimize the risk of large losses. With this authority, the DOL first published guidance on ESG in 1994 under the Interpretive Bulletin 94-1 (IB 94-1). Back then, the term used in the bulletin was "economically targeted investments" (ETIs). (IB 94-1) stated that ETIs could be consistent with fiduciary obligations if the ETI had the same expected rate of return to alternative investments with similar risks. This became known as the "all things being equal test".[10] In an attempt to discourage most fiduciaries from considering ETIs, the DOL replaced (IB 94-1) with Interpretive Bulletin 2008-01 (IB 2008-01) which states that "fiduciary consideration of collateral, noneconomic factors should be rare and carefully documented". [11] In 2015, the DOL again shifted their tone with Interpretive Bulletin 2015-01 (IB 2015-01) which reverted back much of the language to (IB 94-1) but specifically expanded ETIs to include ESG factors and expressed the view that "ESG factors may have a direct relationship to the economic and financial value of the plan's

---

[5] https://www.cato.org/sites/cato.org/files/2020-06/regulation-v43n2-5.pdf
6 https://www.federalregister.gov/documents/2017/02/03/2017-02451/reducing-regulation-and-controlling-regulatory-costs
7 https://www.washingtonexaminer.com/trump-kills-16-regulations-for-every-new-one-crushing-2-for-1-goal
[8] https://www.nytimes.com/2017/02/03/business/dealbook/trump-congress-financial-regulations.html
[9] https://www.nytimes.com/2017/02/03/business/dealbook/trump-congress-financial-regulations.html
10 https://www.federalregister.gov/documents/2015/10/26/2015-27146/interpretive-bulletin-relating-to-the-fiduciary-standard-under-erisa-in-considering-economically
[11] https://www.federalregister.gov/documents/2015/10/26/2015-27146/interpretive-bulletin-relating-to-the-fiduciary-standard-under-erisa-in-considering-economically

investment … and are proper components of the fiduciary's primary analysis".[12] Fearing that they had been too broad in their allowance, the DOL once again tried to clarify with Field Assistance Bulletin 2018-01 (FAB 2018-01). Here it attempted to clarify limitations on (IB 2015-01) saying that "Fiduciaries must not too readily treat ESG factors as economically relevant … and the fiduciaries must always put first economic interests of the plan providing benefits."[13] All of these back-and-forth announcements led to the Proposed Regulation, specifically DOL Proposed Rule RIN 1210-AB95 on June 30th, 2020. Proposed Regulation once again stated "fiduciaries must select investments based solely on financial considerations" and most importantly that "the proposed rule would replace existing guidance on the use of ESG and similar factors in the selection of investments".[14] The Proposed Regulation explicitly states that "it is considered to be an (EO 13771) regulatory action" and thus must abide by the "one in-two out" requirement but fails to make any acknowledgement of the two regulations being removed. Additionally, the Proposed Regulation contradicts itself regarding the directive about the possible economic burden of proposed regulation. In the Proposed Regulation, the concluding statement on regulatory impact states that "The Department does not intend to increase fiduciaries burden of care attendant to such consideration; therefore, and no additional costs are estimated for this requirement".[15] However, earlier in the Proposed Regulation, in accordance with the Congressional Review Act, the Office and Management and Budget (OMB) designated this proposal a major rule because *"it would be likely to result in annual effect on the economy of **$100 Million or more".*** And the DOL specifically admitted that it actually has no certainty to the actual economic burden of the proposal. The DOL did not even know the number of fiduciaries impacted as it notes that "*while the department does not have sufficient data to estimate the number of such fiduciaries, …believes it is small".* Further, the DOL admitted that "*it is unclear how many plans use ESG and similar factors when selecting investments. Similarly, unclear is the total asset value of investments that were selected in this manner".* Multiple financial and legal firms, including ESG Global Advisers and O'Melveny Meyers law firm noted in comments submitted to the DOL, that there will be likely confusion, additional costs to plan beneficiaries and unintended consequences should the proposed rule be adopted in its current form.

This lack of knowledge comes off as willful ignorance, as cursory searches demonstrate that a majority of respondents have already incorporated ESG into their investments. For example, a survey conducted by Russell Investments in 2019 indicated that 82% of respondents have a formalized responsible investment policy and 73% of respondents have explicit quantitative or qualitative ESG factor assessments.[16] This willful ignorance seems more clear as noted in a comment letter submitted in response by a group comprising The American Bankers Association, the Defined Contribution Institutional Investment Association, the Insured Retirement Institute, the

---

12 https://www.dol.gov/sites/dolgov/files/ebsa/about-ebsa/our-activities/resource-center/fact-sheets/etis-and-investment-strategies-that-consider-esg-factors.pdf
13 https://www.dol.gov/agencies/ebsa/employers-and-advisers/guidance/field-assistance-bulletins/2018-01
14 https://www.federalregister.gov/documents/2020/06/30/2020-13705/financial-factors-in-selecting-plan-investments
15 https://www.federalregister.gov/documents/2020/06/30/2020-13705/financial-factors-in-selecting-plan-investments
[16] https://russellinvestments.com/-/media/files/ca/en/corporate/2019-esg-manager-survey-can.pdf?la=en-ca&hash=4249E6D2138DFD3E4BD1F7FA8A00D321941AD5F7

Investment Adviser Association, the Investment Company Institute, the Securities Industry and Financial Markets Association and the SPARK Institute which states "The Department (of Labor) never sought public input (nor input from the ERISA Advisory Council) on the question of financial factors in investment decisions".[17] Major financial institutions made similar comments. BlackRock noted the absence of consultations with the comment "We urge the DOL to engage with the industry to understand how investment options incorporating ESG factors are used in ERISA plans. … And suggesting the DOL could issue a "Request for Information" to *gain a holistic picture of growing trends of ESG integration"*.[18] In a similar theme, Fidelity expressed concern that the DOL appears to have rushed this proposal forward and "(Fidelity) requests the DOL allow adequate time to prepare the documentation and analysis required to review investment options". Additionally, Fidelity noted that the implementation timeline suggested is far too short at the recommended 60 days after final rule publication. Instead, Fidelity proposes that "plan fiduciaries should be afforded at least twelve months before the Rule becomes effective to mitigate potential financial losses that may inadvertently harm plan participants".[19]

The DOL's Proposed Rule sought to address the growing concerns that fiduciaries may be over-emphasizing the importance of non-economic factors including ESG, thereby failing their fiduciary duty of maximizing financial returns.[20] While there is no doubt that fiduciaries must and should act in the best interest of their participants, a number of institutional investors provide commentary indicating that these concerns are overstated. The CEO of Putnam Investments, Robert L. Reynolds noted, "We are not aware of any systemic shortcomings in plans' selection of investments, either in the ESG arena or more broadly."[21] Additionally, the California State Teachers' Retirement System, (CALSTRS) the largest educator-only pension fund in the world, shared similar views and pushed further saying that "one might expect the DOL to more clearly define what specific types of ESG investment trends it is concerned about and provide evidence that ERISA fiduciaries are making those investments on the basis of non-pecuniary criteria" and that "the Proposal states an unsubstantiated position that in turn creates confusion for ESG investors".[22]

One of the issues with the unclear language is that now fiduciaries must take additional measures to prove they are not mismanaging ESG criteria or risk litigation for not following the best interests of plan participants. The Proposed Regulation correctly stated that "in the context of ERISA retirement plans that such interests must be understood to refer to "financial" rather than "nonpecuniary" benefits". This tenor is continued in the Stanford Law Review article *Reconciling*

---

[17] https://www.dol.gov/sites/dolgov/files/EBSA/laws-and-regulations/rules-and-regulations/public-comments/1210-AB95/00123.pdf
[18] https://www.blackrock.com/corporate/literature/publication/dol-financial-factors-in-selecting-plan-investments-073020.pdf
[19] https://www.dol.gov/sites/dolgov/files/EBSA/laws-and-regulations/rules-and-regulations/public-comments/1210-AB95/00673.pdf
[20] https://www.groom.com/resources/dol-proposes-rule-to-crack-down-on-esg/
[21] https://www.dol.gov/sites/dolgov/files/EBSA/laws-and-regulations/rules-and-regulations/public-comments/1210-AB95/00485.pdf
[22] https://www.calstrs.com/sites/main/files/file-attachments/amendmentstohowretirementplansusefunds.pdf?1596645586

*Fiduciary Duty and Social Conscience: The Law and Economics of ESG Investing by a Trustee*. Here the article states that "a pension trustee breaches the duty of loyalty whenever the trustee acts other than to benefit the beneficiaries financially."[23] However, despite the length of this law review and its 400 footnotes, there is no reference to any actual case that has asserted a breach of duties by a fiduciary who considered ESG factors in their investment decisions. With many financial institutions claiming years or decades of experience (State Street claims 35 years & Nuveen claims 50), it would appear the bluster from the DOL regarding these trends, is as CALSTRS stated, unsubstantiated. Furthermore, within the article itself, the authors appear to undercut their own message by stating ""Prudent investment principles," in other words, "allow the use of . . . active management strategies by trustees. These efforts may involve searching for advantageous segments of a market, or for individual bargains in the form of underpriced securities." It follows, therefore, that an ESG investing strategy that involves picking and choosing investments based on ESG factors, or that involves exercising shareholder control rights in light of those factors, could satisfy the prudent investor rule."[24] This viewpoint leads directly to the second point of confusion, performance.

The Proposed Regulation stated, "This proposed regulation is designed in part to make clear that ERISA plan fiduciaries may not invest in ESG vehicles when they understand an underlying investment strategy of the vehicle is to subordinate return or increase risk for the purpose of nonpecuniary objectives". In simple terms, fiduciaries cannot invest in strategies that knowingly underperform just for ESG goals. However, what the notice fails to discuss is how to consider ESG factors that enhance and improve risk-adjusted investment returns over both the short- and long-term. The Sustainability Accounting Standards Board (SASB) was established to propose and establish specific ESG disclosure standards for industries. Based on consultations with over 2700 people in business, government, accounting, law, finance, academia and with fiduciaries representing $23.4 trillion in assets under management, SASB has proposed recommendations for 77 categories of industries regarding ESG disclosure. With numerous companies accepting SASB's recommendations in their published information to shareholders and regulatory authorities, it would appear that ESG factors may be material to every type of security and issuer, both domestic and international. This point is further stated in MSCI's message to the DOL where they "respectfully direct the DOL to a substantial and growing body of detailed empirical research into the ESG investment marketplace that has identified meaningful links between a company's ESG characteristics and financial performance."[25] This message is reiterated firmly in BlackRock's 2020 Client Letter with "Because sustainable investment options have the potential to offer clients better outcomes, we are making sustainability integral to the way BlackRock manages risk, constructs portfolios, designs products, and engages with companies. We believe that sustainability should be

[23] https://review.law.stanford.edu/wp-content/uploads/sites/3/2020/02/Schanzenbach-Sitkoff-72-Stan.-L.-Rev.-381.pdf
[24] https://review.law.stanford.edu/wp-content/uploads/sites/3/2020/02/Schanzenbach-Sitkoff-72-Stan.-L.-Rev.-381.pdf
[25] https://www.msci.com/documents/1296102/21334181/MSCI+Response+1.pdf/4959f04e-6ac2-8f9f-17cf-15026101882e

our new standard for investing."[26] And lastly, Mindy S. Luber published a statement directly at the DOL in the Harvard Law School Forum on Corporate Governance where she states "The evidence is clear that ESG issues pose short-, medium- and long-term financial impacts and risks that place them squarely within the category of material, financial risks that are factored into investment decisions. These impacts range from significant to highly material, with certain ESG issues posing systemic risks. A prudent fiduciary should keep this evidence in mind as a part of their analysis. The Department should clearly acknowledge that ESG issues may in fact pose material short-, medium- and long-term financial impacts and risks to companies and investments."[27]

These comments provide evidence to the argument that fiduciaries who ***do not*** consider ESG factors could in fact be the ones violating their fiduciary responsibility, as these factors help to improve the overall risk-adjusted return profile of investments. This further serves to negate the argument stipulated in the Proposed Regulation. Additionally, while we have established that the DOL has the policies and regulations in place to determine if a fiduciary is acting in the best interests of their participants, there is concern that they may be overstepping their mandate in other points in the proposal.

Within the Proposed Regulation, the DOL stated, "As ESG investing has increased, it has engendered important and substantial questions and inconsistencies, with numerous observers identifying a lack of precision and rigor in the ESG investment marketplace. There is no consensus about what constitutes a genuine ESG investment, and ESG rating systems are often vague and inconsistent". The DOL is correct in pointing out that ESG marketplace has expanded rapidly. The Global Initiative for Sustainable Ratings (GISR) reported more than 125 ESG data providers. GISR further pointed out that with the proliferation of ratings, "it is not uncommon for a large company to annually complete a dozen or more disparate questionnaires leading to ratings that span the spectrum from leading to intermediate to lagging performance. And with competing frameworks, some companies "cherry pick" only favorable results".[28] So, while the DOL correctly identified that the current ESG landscape lacks common standards or frameworks with which we can identify materiality of ESG factors,

concern over the quality and validity of ESG factors in investment decisions is warranted, the relevant question is whether the DOL is the appropriate agency to insure full and truthful disclosure.

In claiming jurisdiction over disclosures in the context of ERISA investments, the DOL pointedly ignored the authority of the United States Securities and Exchange Commission (SEC) as the appropriate agency for the regulation of disclosures that affect investment offerings. For decades, the SEC has been providing investor protections across all scenarios and securities. Existing federal securities laws dating back to the Securities Act of 1933 provide effective regulation. The key piece of this regulation, Rule 10b(5), states "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce… (a) to employ any device, scheme, or artifice to defraud, (b) to make any untrue state of a material fact or omit to state a

[26] https://www.blackrock.com/us/financial-professionals/blackrock-client-letter
[27] https://corpgov.law.harvard.edu/2020/08/26/comment-on-the-proposed-dol-rule-2/
[28] https://business-ethics.com/wp-content/uploads/2011/06/GISR_Brochure_Final_June_2011.pdf

material fact necessary in order to make the statements made, in the light of circumstances in under which they were made, not misleading, or (c) to engage in any act, practice, or course of business which operates or would operate as a fraud of deceit upon any person". [29] The SEC has been researching and evaluating regulations regarding disclosures of ESG considerations for almost 50 years. Beginning with a ruling titled "*Disclosures Pertaining to Matter Involving the Environment and Civil Rights"* Release No. 33-5170. Similar rulings continued in the ensuing decades and in 2019, William Hinman, SEC Director, Division of Corporation Finance presented the SEC's then current position on regulation of ESG disclosures saying "Our disclosure regime emphasizes materiality. Information is material if there is a substantial likelihood that a reasonable investor would consider it important in deciding how to vote or make an investment decision…The flexibility of our principles-based disclosure requirements should result in disclosure that keeps pace with emerging issues, like sustainability matters, without the need for the Commission to continuously add to or update underlying disclosure rules as new issues arise."[30] He goes further to state that "market participants have raised questions about the sufficiency of sustainability disclosures…(and) it appears to me that the market is still evaluating what, if any, additional disclosure on these topics would provide consistently material and useful information…and allowing this evolution to continue should provide market participants with a continued opportunity to sort out the types of information they find useful".[31] More recently, in May 2020, in *Recommendation of the SEC Investor Advisory Committee Relating to ESG Disclosure*, the Committee stated, "The message that we have heard consistently is that investors consider certain ESG information material to their investment and voting decisions, regardless of whether their investment mandates include an "ESG-specific" strategy. Our work has informed us that this information is material to investors regardless of an Issuer's business line, model or geography." And finally, in August 2020, as part of the SEC's finalization of amendments to Regulation S-K, which are the key rules guiding companies' disclosures in registration statements and periodic reports, the dissenting Commissioner Lee stated "It's time for the SEC to lead a discussion – to bring all interested parties to the table and begin to work through how to get investors the standardized, consistent, reliable and comparable ESG disclosures they need to protect their investments and allocate capital".[32] This attitude is wildly different from that of the DOL's concerns about inadequate ESG disclosure affecting ERISA plans, and while the DOL has jurisdiction of ERISA, it is questionable as to why they would not at least defer to the SEC's expertise on truthful disclosure of material facts in the proposed ESG Notice.

While the Final Regulation "walks-back" a direct prohibition of ESG metrics for ERISA fiduciaries, it nonetheless places ESG metrics under scrutiny, with the intent of discouraging fiduciaries of utilizing ESG considerations in their investment approaches. As noted, it did so while failing to seek out industry or academic input, mischaracterizing how prudent fiduciaries currently and potentially could consider ESG metrics as an investment consideration, and usurping the authority of another governmental agency.

---

[29] https://www.law.cornell.edu/cfr/text/17/240.10b-5#

[30] SEC.gov | Applying a Principles-Based Approach to Disclosing Complex, Uncertain and Evolving Risks

[31] SEC.gov | Applying a Principles-Based Approach to Disclosing Complex, Uncertain and Evolving Risks

[32] https://www.sec.gov/news/public-statement/lee-regulation-s-k-2020-08-26

With the transfer of power over to the new Biden Administration, many have predicted that Biden will seek to review and possibly revise the Final Regulation. For example, Morningstar published an article stating, “We expect subregulatory guidance such as FAQs and advisory opinions to help bring things back toward the old status quo” and that “We think it is also likely that a Biden DOL will promulgate new regulations for a selection of ESG funds as default options.”[33] According to analysis, there appears to be at least two scenarios under which the Final Regulation could be either rescinded entirely or modified enough to appease most critics. The first is through a Congressional Review Act (CRA), where both the House of Representatives and the Senate can approve a resolution to overturn a specific regulation. While the use of the CRA was available since 1996 when it was signed into law under President Clinton, it had been successfully used only once prior to the most recent administration. However, with the Trump Administration using it a shocking 16 times, including, amazingly once against regulation passed during his own administration, the precedent for increase use has been established. The second possibility of change involves a new cycle of proposed regulation, which at the minimum includes a review by the OMB, a public comment period of at least 30 days, and then further consideration of comments and reaction and recommendations from the OMB.

ESG investing has been continuing its push into the mainstream and with the increased attention, there are high expectations for the Biden Administration to make changes. The view appears to be that the agencies like the DOL and the SEC will use the reconsideration of the Final Regulation as an opportunity to undertake a deeper and hopefully more sophisticated analysis of ESG metrics. This should include extensive communication with the professional and academic participants who can show how rigorous ESG metrics can, in fact, improve risk-adjusted investment returns while providing quantifiable societal benefits.

[33] https://www.morningstar.com/articles/1011098/biden-administration-will-improve-regulatory-climate-for-sustainable-investing