# DOL Proposes ESG Rule

What ERISA investment fiduciaries should know.

August 2020

**KEY POINTS**

- The DOL proposed a new rule on fiduciary investing that imposes additional due diligence and documentation requirements on plan fiduciaries considering ESG factors in investment decisions.
- The proposed rule would discourage the use of ESG factors in ERISA investment decisions. The proposed rule has some troubling implications for plan investing unrelated to ESG considerations.
- T. Rowe Price has submitted a comment letter outlining concerns with the proposal.

On June 23, 2020, the U.S. Department of Labor issued a proposed rule relating to fiduciary responsibility. The rule is focused on plan fiduciaries' use of environmental, social, and governance (ESG) factors in investment decisions but impacts how fiduciaries make investment decisions more broadly.

The proposed rule, if finalized, would discourage use of ESG factors in plan investment decisions, as well as use of ESG-focused investments. In addition, the proposal would likely encourage more ERISA litigation challenging fiduciary decision-making.

The proposed rule replaces a 1979 rule validating the use of modern portfolio theory in ERISA investment approach (while retaining and augmenting those 1979 principles). In addition, it adds significant focus on how fiduciaries should approach ESG considerations in portfolio management and in oversight of a defined contribution plan investment menu.

## Background

Consideration of ESG factors in investing has long been a controversial topic for the DOL. Through decades, the DOL has issued sub-regulatory guidance describing the extent to which consideration of such factors was permitted for ERISA fiduciaries.

The issue has been highly political. Although the DOL has been consistent in stressing the importance of economic factors in plan investing, Democratic administrations have generally issued guidance more favorable to ESG considerations, and Republican administrations have generally issued guidance more skeptical of these considerations.

Although the current administration had already issued sub-regulatory guidance on ESG in 2018, President Trump directed further consideration and potential regulation, in an April 2019 Executive Order. The DOL's proposed rule results from that order.

## Consideration of investment alternatives required

The proposed rule adds new criteria that all fiduciaries must observe in making investments for ERISA plans (including separate accounts and ERISA plan asset vehicles such as collective investment trusts):

- Fiduciaries must evaluate investments based solely on pecuniary factors with a material effect on the anticipated risk and return;
- Fiduciaries must not subordinate the interests of participants and beneficiaries to unrelated objectives (or to a fiduciary's interests); and
- Fiduciaries must not sacrifice returns or take on additional risk to promote nonpecuniary goals.

In addition to a well-accepted list of considerations (e.g., diversification of the portfolio, liquidity and current return relative to cash needs, etc.) the proposed rule adds a new criterion requiring a fiduciary to consider how the investment compares to available investment alternatives.

This is particularly concerning, as it would be difficult for any fiduciary to meet a standard that requires consideration of any specific available alternative identified with the benefit of hindsight. Unless clarified, this criterion might give rise to unwarranted private litigation.

## Consideration of pecuniary factors alone

In explaining the need to focus solely on pecuniary factors (as opposed to nonpecuniary factors), the proposed rule notes that ESG factors are pecuniary only if they present economic risks or opportunities, and the weight accorded such factors must reflect the impact on risk and return.

To the extent a fiduciary considers ESG factors in investment decisions, the fiduciary must examine the level of diversification, the degree of liquidity, and the potential risk and return of the proposed ESG investment in comparison with other available investments that would play a similar role. In short, consideration of ESG factors requires additional due diligence.

## ESG as a "tie breaker"

Consistent with prior sub-regulatory guidance, the DOL's proposed rule allows ESG to serve as a tie breaker only if the investment selected with ESG considerations in mind is "economically indistinguishable" from an alternative selected without consideration of ESG factors. (In preamble commentary, the DOL suggests that economic comparability will be a rare occurrence.)

If a fiduciary resolves the tie by giving weight to ESG factors, it must maintain additional documentation as to why the ESG-focused investment was considered economically indistinguishable and why the investment was chosen based on plan purposes, diversification, and the financial interests of participants and beneficiaries. In other words, allowing ties to be resolved in favor of ESG requires additional documentation.

## ESG-focused Investments in DC plan menus

In an apparent internal contradiction, the proposed rule has a slightly more forgiving standard for inclusion of an ESG-focused investment in a defined contribution plan menu. The rule allows defined contribution plan fiduciaries to offer ESG-focused investments that are "prudently selected, well-managed and properly diversified" only if the fiduciary restricts itself to "objective risk and return" criteria in selecting and monitoring, and only if the fiduciary maintains the documentation as required above. Nonetheless, the rule prohibits the use of ESG-focused investments as a component of a qualified default investment alternative.

## Next Steps

A number of organizations, including T. Rowe Price, have submitted comments in opposition to the proposed rule.

Members of Congress from both parties have submitted their own letter opposing the DOL's proposed rule. Should the DOL finalize its proposal, there is a possibility that Congress would take action to mitigate the effects of the rule.

While the focus on the economic impacts of ESG investing is generally consistent with T. Rowe Price's approach, we are concerned about the additional burden placed on appropriate consideration of ESG factors as well as those aspects of the proposed rule that have impacts unrelated to ESG investing. We will work to make sure that our perspectives are shared with the Department of Labor.

T. Rowe Price®

T. Rowe Price Retirement Plan Services, Inc.