

July 30, 2020

Office of Regulations and Interpretations  
Employee Benefits Security Administration, Room N-5655  
U.S. Department of Labor  
200 Constitution Avenue NW  
Washington, DC 20210  
Attention: Financial Factors in Selecting Plan Investments Proposed Regulation

**Re: Proposed Rule - RIN 1210-AB95**

To Whom It May Concern:

Thank you for the opportunity to provide comment on the proposed rule. The U.S. Impact Investing Alliance (“the Alliance”) and our members have significant concerns with the U.S. Department of Labor’s (“the Department”) changes to the fiduciary standard for ERISA-regulated retirement plans. Earlier this month, the Alliance submitted a request to extend the comment deadline well beyond the resolution of the COVID-19 pandemic and crisis. We echo that request here and urge regulators to suspend this rulemaking during this time of uncertainty and instability. Lacking proper time to respond, our comments must be similarly truncated and focused on the most pressing issues, though by no means is this an exhaustive account.

First, the substance of the rule rests on faulty assumptions about the current state of the investment market. Specifically, the rule seems to presume that investment strategies based on environmental, social and governance (“ESG”) factors inherently sublimate risk and return considerations to focus on “non-pecuniary considerations.” We will discuss the rich academic and financial literature that illustrates the weakness of this assumption.

Second, we will respond to specific points of the rule that are clearly untenable – the definition of “economically indistinguishable” and the restrictions placed on plans selecting “qualified default investment alternatives” (“QDIA”). We further argue that the proposed rule broadly creates an arbitrary double standard by which ESG funds must be evaluated above and beyond the demands placed on non-ESG alternatives.

Finally, we will address the inadequacy of the cost benefit analysis performed by the Department.

The Alliance is an organization committed to catalyzing the growth of impact investing in the United States. Members of our boards and councils include individual and institutional investors collectively owning hundreds of billions of dollars of invested assets, in addition to asset and fund managers collectively managing trillions of dollars in assets. We define impact investing broadly to include those investments that create financial returns alongside measurable and positive social, economic and environmental impacts across asset classes. The Alliance considers “ESG investing” as one subset of the broader impact investing market.

The Alliance would counter the assertion within the proposed rule that impact investing-related terms “do not have a uniform meaning.” While it is true that impact investing encompasses a wide range of asset classes and investment strategies, market stakeholders have coalesced around common definitions for terms as the impact investing market has scaled. Further, ESG investing – sometimes

referred to as sustainable investing<sup>1</sup> – is one of the most well-researched areas within the broader field, leading to the development and broad use of commonly applied standards, such as those by the Sustainability Accounting Standards Board (“SASB”), which categorizes material ESG issues across 77 industries. For the purposes of this comment letter, the Alliance is focused solely on ESG factors and related investment strategies which incorporate those factors in investment decision making.

### **Research and Market Insights Show that ESG Factors Drive Financial Performance**

The Department’s proposal is predicated on the misconception that ESG factors are “non-pecuniary.” Given the breadth of academic research and data indicating that select ESG factors are financially material, help reduce long-term risk and are being incorporated into mainstream investment strategies, the Alliance challenges this foundational assumption. In the last six years alone, academics and industry leaders have published a flurry of empirical studies on the financial implications of ESG factors, and unfortunately, the proposed rule fails to take them into account. Throughout this section, the Alliance will provide just a sample of the broader evidence sets that indicate that the consideration of ESG factors align with the principles of fiduciary duty.

First and foremost, the integration of ESG factors into investment strategies has often proven to create financial opportunities and lead to outperformance. Studies have found that the mechanisms that link ESG to cash flow are as follows, “(1) facilitating top-line growth, (2) reducing costs, (3) minimizing regulatory and legal interventions, (4) increasing employee productivity, and (5) optimizing investment and capital expenditures”.<sup>2</sup> A 2015 meta-study of over 200 academic studies and industry reports revealed that “prudent sustainability practices” and profitability “are not incompatible, but in fact wholly complementary.”<sup>3</sup> Specifically, 88% of the research analyzed demonstrated that positive ESG performance correlates with the improved operational performance of businesses, and in 80% of the studies, good sustainability practices by businesses were positively linked to superior stock price performance. Further, 90% of the research revealed that “sound sustainability standards lower the cost of capital of companies.”<sup>4</sup> Given the robust evidence in favor, the authors conclude that investors should consider ESG factors in their decision-making in order to adequately pursue the best financial results.

These findings are reinforced by several other studies, including a 2014 analysis of 180 U.S. companies in which the corporations that voluntarily adopted sustainability policies “significantly outperformed[ed] their counterparts over the long-term.”<sup>5</sup> Likewise, in the 2015 MSCI paper, “Can ESG Add Alpha?” the

---

<sup>1</sup> According to the European Commission, “Sustainable finance generally refers to the process of taking due account of environmental and social considerations when making investment decisions, leading to increased investment in longer-term and sustainable activities.” Available at: [https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance/what-sustainable-finance\\_en](https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance/what-sustainable-finance_en)

<sup>2</sup> Henisz, Witold and Koller, Tim and Nuttall, Robin, Five Ways that ESG Creates Value, McKinsey Quarterly, (Nov 2019.) Available at: [https://www.mckinsey.com/business-functions/strategy-and-corporate-finance/our-insights/five-ways-that-esg-creates-value?cid=soc-web&fbclid=IwAR3onKpp8NgbyctliHjvZHns7HcqFUhaKamqMamTYZE8eE4aC10BbRgm\\_U](https://www.mckinsey.com/business-functions/strategy-and-corporate-finance/our-insights/five-ways-that-esg-creates-value?cid=soc-web&fbclid=IwAR3onKpp8NgbyctliHjvZHns7HcqFUhaKamqMamTYZE8eE4aC10BbRgm_U)

<sup>3</sup> Clark, Gordon L. and Feiner, Andreas and Viehs, Michael, From the Stockholder to the Stakeholder: How Sustainability Can Drive Financial Outperformance (March 5, 2015). Available at SSRN: <https://ssrn.com/abstract=2508281>

<sup>4</sup> Ibid.

<sup>5</sup> Eccles, Robert G. and Ioannou, Ioannis and Serafeim, George, The Impact of Corporate Sustainability on Organizational Processes and Performance (December 23, 2014). Management Science, Volume 60, Issue 11, pp.

findings trend in the affirmative – ESG can indeed add alpha. Upon a longitudinal analysis of two ESG investment strategies – ESG tilt and ESG momentum – the authors found that both strategies outperformed the global benchmark. Further, they concluded that the outperformance may be attributed to the ESG factors themselves.<sup>6</sup>

The financial materiality of ESG factors is also the basis for SASB’s overarching framework used by companies and investors alike. For sense of scale, SASB’s Investor Advisory Group, the SASB Alliance and those that have licensed the standards for use in investment processes are collectively comprised of 145 asset owners and asset managers representing approximately \$53.2 trillion in assets under management. Further, companies across 60 industries in 34 countries report using SASB metrics.<sup>7</sup>

Using SASB’s “Materiality Map,” researchers analyzed the data from over 2,300 companies and found that companies with positive ratings on SASB’s material sustainability issues “significantly” outperformed those that ranked poorly on those same issues.<sup>8</sup> Conversely, the same analysis found that companies with good ratings on immaterial sustainability issues did not outperform those with poor ratings on the same issues. A similar study by Russell Investments using SASB also found that material ESG scores are better indicators of financial return compared to scores related to both material and immaterial ESG issues.<sup>9</sup> Finally, using SASB’s definition of materiality, researchers found that banks that consistently achieved high ESG scores on material issues delivered higher risk-adjusted returns compared to their counterparts that achieved lower scores, (the opposite being true for immaterial issues) suggesting that “a focus on material sustainability issues is likely to coincide with enhanced financial returns.”<sup>10</sup> These findings illustrate the important point that, while not always, ESG factors are often financially relevant and should therefore be considered within a fiduciary’s due diligence. It also indicates the sophistication with which emerging market standards and generally accepted investment strategies are able to differentiate between financially material (or pecuniary) factors and immaterial factors.

Short of creating financial value, as was argued in the cited research above, further studies have shown that ESG investments are at least on par with their non-ESG counterparts. In a large meta-analysis of around 2,200 individual studies, the vast majority of the studies revealed a positive correlation between

---

2835-2857, February 2014, Available at SSRN: <https://ssrn.com/abstract=1964011> or <http://dx.doi.org/10.2139/ssrn.1964011>

<sup>6</sup> Nagy, Zoltán and Kassam, Altaf and Lee, Linda-Eling, Can ESG Add Alpha? (June 2015). Available at MSCI: <https://www.msci.com/www/research-paper/research-insight-can-esg-add/0182813629>

<sup>7</sup> Guillot, Janine, Sustainability Accounting Standards Board Public Comments Re: Proposed rule on Financial Factors in Selecting Plan Investments (RIN 1210-AB95), (July 21, 2020).

<sup>8</sup> Khan, Mozaffar and Serafeim, George and Yoon, Aaron, Corporate Sustainability: First Evidence on Materiality (November 9, 2016). The Accounting Review, Vol. 91, No. 6, pp. 1697-1724., Available at SSRN: <https://ssrn.com/abstract=2575912> or <http://dx.doi.org/10.2139/ssrn.2575912>

<sup>9</sup> Russell Investments, Materiality matters: Targeting the ESG issues that can impact performance, (February 2018). Available at: <https://russellinvestments.com/-/media/files/us/insights/institutions/governance/materiality-matters.pdf?la=en>

<sup>10</sup> The European Investment Bank (EIB), the Global Alliance for Banking on Values (GABV), Deloitte and KKS Advisors, Do sustainable banks outperform? Driving value creation through ESG practices, (May 2020). Available at: <https://www2.deloitte.com/uk/en/pages/financial-services/articles/driving-value-creation-through-esg-practices.html>

ESG factors and corporate financial performance.<sup>11</sup> Approximately 90% of the studies indicated a non-negative correlation between ESG factors and financial performance.<sup>12</sup> These aggregated findings suggest that ESG factors rarely result in negative outcomes and can often result in outperformance. Further, a 2017 report commissioned by the U.S. Department of Labor included a literature review of the potential trade-offs between ESG factors and financial performance and found that “ESG investments provide performance at least comparable to that of non-ESG investments.”<sup>13, 14</sup>

By the same token, both corporations and investors are increasingly understanding the financial value that ESG strategies can create. In a McKinsey survey of 340 respondents from around 40 companies, 44% cited seeking business and growth opportunities in their deciding factors for addressing sustainability issues.<sup>15</sup> A 2019 report from the same firm reveals that investors concur that ESG correlates with long-term financial value. Reportedly over 80% of investment leaders and professionals indicated that they believe “ESG programs will contribute more shareholder value in five years than today.” Additionally, 57% of all respondents agree that ESG creates shareholder value, and only a scant 3% reported believing they reduce shareholder value.<sup>16</sup>

Dispelling the myth that ESG strategies require sacrificing financial returns is critical, as the proposed rule would arbitrarily impose a higher burden on fiduciaries for incorporating ESG factors, as we will explore further in the next section. This myth is also reiterated explicitly in the Department’s inadequate cost benefit analysis, also discussed further in this letter.

---

<sup>11</sup> Friede, Gunnar and Busch, Timo and Bassen, Alexander, ESG and Financial Performance: Aggregated Evidence from More than 2000 Empirical Studies (October 22, 2015). *Journal of Sustainable Finance & Investment*, Volume 5, Issue 4, p. 210-233, 2015, DOI: 10.1080/20430795.2015.1118917, Available at SSRN: <https://ssrn.com/abstract=2699610>

<sup>12</sup> Ibid.

<sup>13</sup> Ezeokoli, Ogechukwu and Layne, China and Statman, Mier and Urdapilleta, Oswaldo, Environment, Social and Governance (ESG) Investment Tools: A Review of the Current Field, Prepared for the U.S. Department of Labor, (December 2017). Available at: <https://www.dol.gov/sites/dolgov/files/OASP/legacy/files/ESG-Investment-Tools-Review-of-the-Current-Field.pdf>.

<sup>14</sup> It is worth noting that the Department cites the broader report in the background information that accompanied the proposed rule, writing “[a]s 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.” The Alliance refutes that conclusion, given the evidence provided in this letter that suggests that ESG standards have been steadily strengthened as the market has scaled and entered the mainstream. While it is true that the impact investing field writ large is quite nuanced, containing a plethora of investment strategies and asset classes, ESG investing is perhaps one of the most well-defined and understood. Further, if the Department’s goal is to improve clarity around ESG investing, the proposed rule will in fact result in less clarity, given that it effectively discourages investing in funds labeled as ESG. Finally on this point, while the Alliance appreciates the Department’s review of the literature in the 2017 report, we hope that regulators will consider repeating the exercise with the many academic studies that have been published in the interim, some of which are cited in this comment letter, before proceeding with this rulemaking.

<sup>15</sup> Berg, Achim and Schlag, Nils and Stuchtey, Martin, Getting the most out of your sustainability program,” (August 1, 2015). Available at McKinsey: <https://www.mckinsey.com/industries/retail/our-insights/getting-the-most-out-of-your-sustainability-program>

<sup>16</sup> Delevingne, Lindsay and Gründler, Anna and Kane, Sean and Koller, Tim, The ESG premium: New perspectives on value and performance (February 12, 2020). Available at McKinsey: <https://www.mckinsey.com/business-functions/sustainability/our-insights/the-esg-premium-new-perspectives-on-value-and-performance>

Beyond the creation of financial value, the incorporation of ESG in investment strategies is also critical for mitigating risk, particularly long-term risk. As Fiona Reynolds, Chief Executive Officer of Principles for Responsible Investment recently wrote in the *Wall Street Journal*, “ESG isn’t an asset class, but rather prudent risk management.”<sup>17</sup> Reynolds’ observation has been borne out extensively in academic and industry research. A recent study found that ESG factors are related to a company’s valuation and performance, both through systematic and idiosyncratic risk profiles, meaning that fluctuations in a company’s ESG characteristics ought to be considered as a financial indicator.<sup>18</sup> Similarly, an empirical analysis from 2019 linking ESG performance to credit risk demonstrated that higher-performing ESG companies “experience lower incidence of material adverse events,” while lower-performing companies experience more adversely material events.<sup>19</sup>

Moreover, a study from the year prior argued that traditional financial risk assessment focused solely on monetary returns is “insufficient” in accounting for macro-level trends in which the micro-level considerations preside.<sup>20</sup> In the 2015 McKinsey study mentioned above, 90% of the corporations surveyed cited specific risk concerns for their decision to address sustainability concerns.<sup>21</sup>

Coincidentally, this rulemaking is taking place during what could be considered a test case for understanding the financial implications of systemic risk. The COVID-19 pandemic, related economic downturn and nationwide protests have reinforced what many investors have long known – failing to account for systemic risks endangers financial returns down the line. Factors that may, at one point, have been considered immaterial – such as employee access to health care or internal diversity, equity and inclusion (“DEI”) practices – are now having significant implications for a corporation’s bottom line. In fact, an analysis published in June 2020 revealed that positive public sentiment surrounding a company’s policies responding to the COVID-19 pandemic (in relation to employees, supply chains and operations) are associated with less negative financial returns.<sup>22</sup>

Of course, these broader corporate trends have implications for investors. Initial data indicates that sustainable investments strategies are proving to be more resilient than non-sustainable strategies in response to the pandemic and economic downturn. A Morningstar analysis found that sustainable

---

<sup>17</sup> Reynolds, Fiona, ESG Is Risk Management, Not an Asset Class, (June 29, 2020). Available at Wall Street Journal: <https://www.wsj.com/articles/esg-is-risk-management-not-an-asset-class-11593453762>

<sup>18</sup> Giese, Guido and Lee, Linda-Eling and Melas, Dimitris and Nagy, Zoltán and Nishikawa, Laura, Foundations of ESG Investing: How ESG Affects Equity Valuation, Risk, and Performance, (July 2019). Available at the Journal of Portfolio Management: <https://jpm.pm-research.com/content/45/5/69.abstract>

<sup>19</sup> Henisz, Witold and McGlinch, James, ESG, Material Credit Events, and Credit Risk, Journal of Applied Corporate Finance, Volume 31, Number 2, Spring 2019. Available at Truevalue Labs: <https://www.truevaluelabs.com/blog/in-brief-esg-material-credit-events-and-credit-risk-2?hsCtaTracking=aef42691-25a3-42a7-b948-a57f22bdbb95%7Cc14ac8d9-63b0-4df9-8404-b7ebee63cd6f>

<sup>20</sup> Hawley, James P. and Lukomnik, Jon, The Third, System Stage of Corporate Governance: Why Institutional Investors Need to Move Beyond Modern Portfolio Theory (February 21, 2018). Available at SSRN: <https://ssrn.com/abstract=3127767> or <http://dx.doi.org/10.2139/ssrn.3127767>

<sup>21</sup> Berg, Achim and Schlag, Nils and Stuchtey, Martin, Getting the most out of your sustainability program,” (August 1, 2015). Available at McKinsey: <https://www.mckinsey.com/industries/retail/our-insights/getting-the-most-out-of-your-sustainability-program>

<sup>22</sup> Cheema-Fox, Alexander and LaPerla, Bridget Realmuto and Serafeim, George and Wang, Hui, Corporate Resilience and Response During COVID-19 (June 23, 2020). Harvard Business School Accounting & Management Unit Working Paper No. 20-108, Available at SSRN: <https://ssrn.com/abstract=3578167> or <http://dx.doi.org/10.2139/ssrn.3578167>

equity funds proved to be more resilient than traditional alternatives in the first quarter of 2020: “Seven out of 10 sustainable equity funds finished in the top halves of their Morningstar Categories, and 24 of 26 environmental, social, and governance-tilted index funds outperformed their closest conventional counterparts.”<sup>23</sup> Additionally, researchers have leveraged the pandemic as a natural experiment through which to understand how ESG is so effective in mitigating risk. Initial findings highlight the critical importance of “considering sustainability criteria to mitigate uncertainty,”<sup>24</sup> something that will unfortunately be in no short supply in the coming months and years.

Of course, even setting aside the COVID-19 pandemic, climate change-related risks continue to put significant pressure on markets – pressure that will only continue to mount as time passes. The National Bureau of Economic Research projects that at its current pace, climate change could reduce the U.S. GDP by 10% over the next eight decades.<sup>25</sup> Further, a 2019 study revealed that 215 of the largest companies globally valued the climate change-related risks at approximately \$1 trillion, many reporting the effects likely to hit their businesses within five years.<sup>26</sup>

Ignoring long-term considerations, such as climate risks, creates dire financial consequences, but it also limits opportunities. A 2017 *Harvard Business Review* article found that companies operating under a “true long-term mindset have consistently outperformed their industry peers since 2001 across almost every financial measure that matters.”<sup>27</sup> Given the risks and opportunity costs associated with ignoring long-term considerations, the Alliance argues that the proposed rule could force fiduciaries to violate the duty of impartiality. Under this standard, fiduciaries are required to balance the interests of various groups of plan participants who might have diverging interests. As systemic risks, such as climate change and global pandemics, compound over time, the retirement benefits of younger participants could be endangered disproportionately, meaning that discouraging the consideration of long-term ESG issues by fiduciaries could lead to a violation of the impartiality standard.

Given the plethora of evidence that suggests that ESG factors are a value-add for investors, it is no surprise that ESG investing has entered into the mainstream. According to the Forum for Sustainable and Responsible Investment (“US SIF”), as of 2018, there is \$12 trillion invested in sustainable or ESG funds – or one in every four investment dollars in the United States – which is up nearly 40% from just the 2016 numbers.<sup>28</sup> Larry Fink, Chairman and CEO of BlackRock, the largest asset manager globally, has

---

<sup>23</sup> Hale, Jon, Sustainable Funds Weather the First Quarter Better than Conventional Funds, (April 3, 2020). Available at Morningstar: <https://www.morningstar.com/articles/976361/sustainable-funds-weather-the-first-quarter-better-than-conventional-funds>.

<sup>24</sup> Mahmoud, Ola and Meyer, Julia, Sustainability in the Time of Uncertainty (May 1, 2020). Available at SSRN: <https://ssrn.com/abstract=3597700> or <http://dx.doi.org/10.2139/ssrn.3597700>

<sup>25</sup> Ramani, Veena, Addressing Climate as a Systemic Risk, (June 1, 2020). Available at Ceres: <https://www.ceres.org/regulating-climate-financial-risk>

<sup>26</sup> CDP, World’s biggest companies face \$1 trillion in climate change risks, (June 4, 2019). Available at: <https://www.cdp.net/en/articles/media/worlds-biggest-companies-face-1-trillion-in-climate-change-risks>

<sup>27</sup> Barton, Dominic and Manyika, James and Williamson, Sarah Keohane, Finally, Evidence That Managing for the Long Term Pays Off, (February 9, 2017). Available at Harvard Business Review: <https://hbr.org/2017/02/finally-proof-that-managing-for-the-long-term-pays-off>

<sup>28</sup> US SIF Foundation, Report on US Sustainable, Responsible and Impact Investing Trends, (2018). Available at: <https://www.ussif.org/currentandpast>

publicly and repeatedly linked sustainability factors with long-term value creation.<sup>29</sup> Additionally, earlier this year Japan's Government Pension Investment Fund – the world's largest pension fund – along with the California State Teachers' Retirement System (CalSTRS) and the UK-based USS Investment Management issued a joint statement urging their partners and portfolio companies to enhance their ESG disclosure practices for the sake of pursuing long-term financial value.<sup>30</sup>

Finally, an industry that has been at the center of the increase in ESG is private equity, with large firms such as Ares Management, Apollo Global Management, KKR, Partners Group and TPG beginning to integrate ESG strategies into their core investment strategies. Further, US SIF's 2018 report named private equity funds as one of the fastest growing areas of sustainable investing.<sup>31</sup>

In June of this year, the Department of Labor published an Information Letter allowing for private equity investment options to be included in defined contribution plans under ERISA. The Department's public release states, "[a]dding private equity investments to such professionally managed investment funds would increase the range of investment opportunities available to 401(k)-type plan options."<sup>32</sup> The Department's stated intent is to increase investment options under ERISA, but the proposed rule at issue for these comments will only result in restricted investment opportunities. The proposed rule also undercuts the June guidance, as ESG integration is a growing practice in the private equity industry and in the broader capital markets. The arbitrary exclusion of ESG investments from QDIAs (discussed in the following section) is a particularly egregious example of this fact.

In summation, the Alliance is concerned that the Department's proposed rule on ESG is misaligned with broader trends and will unnecessarily stifle innovation in a rapidly growing market. The Alliance requests that regulators examine the vast array of research presented here and by other commenters in order to better incorporate such evidence of the materiality of ESG factors into the Department's ERISA framework. The importance of upholding fiduciary duty for plan beneficiaries is not in question, but the Alliance disagrees with the proposed rule's assertion that the consideration of ESG factors is misaligned with said fiduciary duty. In fact, analyses have shown that ESG integration does not tend to cause the portfolio to financially suffer, and "may even result in improved returns on a risk-adjusted basis, especially over longer time horizons."<sup>33</sup> We echo the words of a recent report examining fiduciary duty in the 21<sup>st</sup> century that captured it best: "Failing to consider long-term investment value drivers, which include environmental, social and governance issues, in investment practice is a failure of fiduciary duty."<sup>34</sup>

---

<sup>29</sup> Fink, Larry, A Fundamental Reshaping of Finance, (January 21, 2020). Available at BlackRock:

<https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter>

<sup>30</sup> Ailman, Christopher and Mizuno, Hiromichi and Pilcher, Simon, Our Partnership for Sustainable Capital Markets, (March 2020). Available at:

[https://www.gpif.go.jp/en/investment/Our\\_Partnership\\_for\\_Sustainable\\_Capital\\_Markets.pdf](https://www.gpif.go.jp/en/investment/Our_Partnership_for_Sustainable_Capital_Markets.pdf)

<sup>31</sup> US SIF Foundation, Report on US Sustainable, Responsible and Impact Investing Trends, (2018). Available at:

<https://www.ussif.org/currentandpast>

<sup>32</sup> U.S. Department of Labor, Information Letter 06-03-2020, Available at:

<https://www.dol.gov/newsroom/releases/ebsa/ebsa20200603-0>

<sup>33</sup> Gary, Susan N., Best Interests in the Long Term: Fiduciary Duties and ESG Integration (April 17, 2019). 90

University of Colorado Law Review 731 (2019), Available at SSRN: <https://ssrn.com/abstract=3149856> or

<http://dx.doi.org/10.2139/ssrn.3149856>

<sup>34</sup> Rory Sullivan, Will Martindale, Elodie Feller and Anna Bordon, Fiduciary Duty in the 21<sup>st</sup> Century, 2015.

## **Burdensome and Anticompetitive Effects of the Proposed Rule**

Turning to the specific language of the proposed rule, we will now discuss the ways in which its terms are burdensome for plan sponsors (and by extension participants) and anticompetitive in nature. We respond to two items on which the Department requested specific comment – the novel “economically indistinguishable test”<sup>35</sup> and the prohibition on the selection or inclusion of ESG funds for qualified default investment alternatives (“QDIA rule”).<sup>36</sup> We will also discuss the various ways in which the proposed rule creates burdensome double standards for ESG funds.

The Department acknowledges that based on existing guidance plan sponsors have generally come to understand the existence of a “tie-breaker rule.” As understood, a fiduciary, having completed all standard and prudent financial analysis of two investment alternatives and finding them to have equivalent risk and return profiles, could weigh additional considerations, such as ESG factors not included in the economic analysis in “breaking the tie”.

The proposed rule, despite some assertions by the Department to the contrary, will eliminate this protection. Simply put – and in response to the Department’s specific inquiry – no two investment alternatives will ever meet the standard of “economically indistinguishable” as laid out in the proposed rule. The raft of variables enumerated by the Department that must be considered in such a determination are so many and so complex that an unambiguous determination between two similar investments is not a realistic expectation. Indeed, were it not for the arbitrary and singular focus of the proposed rule on consideration of ESG factors, the economically indistinguishable test would render it impossible for a fiduciary to ever select between two investment alternatives without incurring its burdensome documentation requirements. In practice, a fiduciary must be granted some margin for judgement on behalf of their beneficiaries, and it is for this reason that fiduciaries carry a duty of good faith.

As the Department itself notes, there has been no mad dash to make use of the current “tie-breaker” rule for unreasonable applications, nor have we seen any evidence of plan participants challenging its proper application. However, we believe the “tie-breaker” process does provide useful safe harbor to plan sponsors in two important and necessary ways.

First, as alluded to earlier in our comments, a growing number of investors are adopting a philosophy of “long-termism,” a general phrase that refers to the practice of extending the horizon of economic analysis to account for the true cycle of business value creation. This is particularly important for investors – such as younger plan participants – who are indeed planning decades hence. Long-termism calls for the consideration of broader systemic risks that will present as economically material factors over the course of long investment horizons, but not within the granularity of a quarterly or annual report.<sup>37</sup> A responsible fiduciary could find two investment alternatives to be equivalent in terms of

---

<sup>35</sup> § 2550.404a-1(c)(2)

<sup>36</sup> § 2550.404a-1(c)(3)(iii)

<sup>37</sup> For instance, Roger L. Martin writes that:

“One reason the question of short-termism still hasn’t been settled is that the answer is fundamentally unknowable. There is no control group; we can’t compare the performance of America with short-termism to that of America devoid of short-termism — or even prove beyond a doubt that short-termism exists in the first place.”



traditional risk and return analysis, but with one having a compelling “long-term” analysis that is difficult to quantify. We believe fiduciaries should have the reasonable opportunity to include this superior investment alternative without facing the onerous documentation requirements included in the proposed rule.

Second, there is well-documented and rising demand on the part of investors to be able to incorporate their values or beliefs in investment decision-making. We respect that as fiduciaries, plan sponsors must maintain the “eye singular” to financial performance, but the current “tie-breaker” rule gives leeway for fiduciaries to also respect the values and principles of individual plan participants. As we discuss in our comments on the Department’s cost benefit analysis of the proposed rule, prohibiting such consideration opens the risk of different, constitutionally grounded litigation. We also fear that limiting the ability of plans to account for these factors could lead to greater incidence of regulatory arbitrage, with more plan sponsors seeking to fit the requirements of a church plan exemption, for instance.

In both instances detailed above, the current “tie-breaker” rule allows for the good faith execution of a plan sponsor’s fiduciary duty while maintaining strong protections for plan participants. As such, we believe the Department should not advance the proposed rule as it concerns the novel “economically indistinguishable” test.

Turning now to the proposed rule’s treatment of QDIA selections, we believe this represents one of the most anticompetitive and internally inconsistent actions taken by the Department. The proposed rule serves to prohibit the inclusion of ESG funds – even those judged to be economically superior on purely financial grounds – in a defined contribution plan’s default allocation.

Given that the Department has recognized that ESG factors can be considered as material, it is difficult to comprehend what logic motivates the proposed § 2550.404a-1(c)(3)(iii). That this prohibition extends even so far as to restrict inclusion of funds with names or marketing to suggest consideration of ESG factors, irrespective of any evaluation by plan fiduciaries to determine if and how those factors are actually considered, indicates that the proposed rule is not motivated by concerns about financial performance of such funds.

Thus, the proposed rule will place fiduciaries in impossible positions wherein they cannot meet their duties to plan participants because the financially superior investment alternative cannot be selected due to factors that are, by the Department’s definition, non-financial in nature. This can only be viewed as an arbitrary prohibition of certain investment alternatives. We will discuss in our comments on the cost benefit analysis the unambiguously negative economic effects this will have on ERISA-regulated funds, and by extension, society.

The proposed rule’s emphasis on how funds are branded is also difficult to reconcile with the Department’s apparent concern with participant confusion over the terminology used to demarcate investment alternatives that are incorporating ESG criteria. It would seem that the proposed rule discourages use of terms like “ESG,” “sustainable,” or “green” in an investment fund name more than it

---

Given the uncertainty, it seems inappropriate for the Department to fall definitively on one side of the debate, nor should it be in the business of placing arbitrary barriers to obstruct a fiduciary’s good faith consideration of long-term factors. Martin, Roger L., Yes, Short-Termism Really is a Problem (October 9, 2015), Harvard Business Review, Available at: <https://hbr.org/2015/10/yes-short-termism-really-is-a-problem>

discourages actual incorporation of ESG analysis into investment decisions. In effect, the proposed rule will cause investment alternatives to become more opaque to plan sponsors and participants alike.

And thus, it must be stated that the entirety of the proposed rule would seem to create an unnecessary and arbitrary standard for inclusion of investment alternatives that consider ESG analysis. Take for instance the following passage included in the proposed § 2550.404a-1(c)(1) (emphasis added):

Environmental, social, corporate governance, or other similarly oriented considerations are pecuniary factors only if they present economic risks or opportunities that qualified investment professionals would treat as material economic considerations under generally accepted investment theories. *The weight given to those factors should appropriately reflect a prudent assessment of their impact on risk and return.*

This is redundant, and in stating as much, the proposed rule offers no guidance but to reiterate the meaning of prudent investment evaluation. However, that the Department deems it necessary to reiterate will suggest to any reasonable person that a specific and higher standard is being applied to the consideration of ESG factors. Given the evidence presented earlier in our comments surrounding the well-established academic and financial literature documenting the materiality of ESG factors, this higher standard is unwarranted and harmful to plan participants.

This point is driven home by the subsequent sentences:

Fiduciaries considering environmental, social, corporate governance, or other similarly oriented factors as pecuniary factors are also required to examine the level of diversification, degree of liquidity, and the potential risk-return in comparison with other available alternative investments that would play a similar role in their plans' portfolios.

Inclusion of this passage begs the question of whether fiduciaries neglecting to consider environmental, social, corporate governance or other similarly oriented factors – even in the face of the tremendous body of evidence suggesting they are material – would also be asked to examine their own selected alternatives in comparison with available alternatives that do take such factors into account.

Removing the problematic, redundant or illogical components of the rule would render it largely inert. As such, we strongly encourage the Department to take no further action on the proposed rule. If the Department is aware of some public outcry from plan sponsors or participants for further clarity on the incorporation of ESG issues, we suggest that the proper course of action would be to initiate a new request for information allowing the public to share their specific and current concerns with the treatment of ESG investments under ERISA. This body of input could form the basis of a more effective set of guidance or a new rulemaking, were one justified by the concerns raised.

### **Cost Benefit Analysis**

Finally, the proposed rule lacks a meaningful analysis of the costs and benefits that plan participants and sponsors will be forced to incur as a result of this rule. We strongly urge the Department to revisit this analysis, including the faulty assumptions it currently rests on, and to conduct further consultation with affected parties before preparing a final rule. We firmly believe that adequate analysis would demonstrate that the costs of the proposed rule are too great and the benefits lacking.

The Department’s benefits analysis is grounded entirely on two false premises. First, that the rule will generally cause plans to change investment selections to favor non-ESG products, and that “these selected investments’ returns will generally tend to be higher over the long run.” Second, the rule posits that “as plans invest less in actively managed ESG mutual funds, they may instead select mutual funds with lower fees.”

The first premise has already been addressed in our comments, but to reiterate for clarity, there is abundant evidence that many ESG funds have shown the ability to meaningfully outperform comparable investment alternatives. It is our belief that the effect of this rule will be to restrict plan participants’ access to such options and therefore will restrict plan performance over time.

The second premise does not stand up to even passing scrutiny. For instance, a 2019 analysis by Bloomberg found that newly created ESG exchange traded funds “charge an average \$2 for every \$1,000 invested, half the median fee of [similar] funds in the U.S.”<sup>38</sup> The rapid growth of the market for ESG investment products has – as would be expected – led to intense competition on price and fees.<sup>39</sup> The Department is thus proposing to intervene in a functioning, competitive market, an action that will inevitably lead to higher fees and thus direct costs incurred by plan participants.

Furthermore, the proposed rule seems to indicate a preference for passive investment strategies that has never been articulated by the Department previously. Indeed, such a statement flies in contrast to the previously mentioned June 3, 2020, Information Letter on the inclusion of private equity as appropriate investment alternatives for ERISA-regulated plans. If this preference for passive management is applied across all investment selections, then there will be far reaching effects as plan sponsors are now required to revisit every actively managed investment under this new light. On the other hand, if this preference is only applied to actively managed ESG products, then this is another indication that the department is arbitrarily imposing a higher standard on ESG investments than is applied to non-ESG alternatives. In either case, the Department has not addressed the realistic costs of this new preference for passively managed investments.

Turning to the Department’s analysis of costs, the Department has failed to account for a number of substantial costs and burdens that would be placed on plan sponsors and participants under the proposed rule. These unaccounted-for costs stem both from the regulatory and compliance burden being imposed as well as the anticompetitive effects of the rule’s design.

In addressing the proposed rule’s expected burden on plan sponsors looking to incorporate ESG products based on their superior financial risk and return profiles, the analysis states that “the Department does not intend to increase fiduciaries’ burden of care attendant to such consideration.” Thus, the Department intends to wave away the attendant costs of the proposed rule; however, this assertion does not stand up to scrutiny.

If it is indeed the case that the rule provides no new guidance to plan sponsors incorporating ESG funds based on purely financial analysis, then the rule is redundant and without benefit. If that is the case,

---

<sup>38</sup> Pickert, Read and Chasan, Emily, Ethical Investing Has Never Been Cheaper, (March 15, 2019). Available at Bloomberg: <https://www.bloomberg.com/news/articles/2019-03-15/ethical-funds-have-never-been-cheaper-as-vanguard-spurs-fee-war>

<sup>39</sup> Kashner, Elisabeth, ETF Fee War Hits ESG and Active Management, (January 22, 2020). Available at: <https://insight.factset.com/etf-fee-war-hits-esg-and-active-management>

then even trivial costs, by definition, are a net drain on societal resources. However, despite the Department's assertion, it is in fact far more likely that, if adopted, the proposed rule would have the effect of increasing the real or perceived burden of including ESG funds as investment alternatives. Any reasonable person would understand the Department's actions to be an indication of heightened scrutiny of ESG practices. The inevitable result will be that, in certain instances, plan sponsors will be compelled to select otherwise inferior non-ESG investment alternatives solely because of the regulatory cost associated with selecting an ESG alternative. For this reason, the proposed rule can be expected to reduce plan performance and impose costs in the form of lower returns for plan participants.

Furthermore, as alluded to above, the intervention of the Department into a competitive market will have the effect of reducing pressure on pricing and fees for non-ESG investment managers. As the proposed rule effectively eliminates for consideration a large and growing segment of the market for ERISA compliant investment alternatives, it cannot be assumed that this effect will be insubstantial. Economic theory is unambiguous that intervention in competitive markets will result in higher costs and/or reduced performance for plan participants, and rigorous analysis has shown that the mutual fund market in particular is competitive.<sup>40</sup>

The Department acknowledges that "as a result of this proposed rule, participants invested in ESG funds would have to pick a new fund that may not be comparable from their perspective." While it is true that "similar disruptions occur when plan fiduciaries routinely change designated investment alternative," those disruptions do not typically occur in the midst of a global pandemic and at the inducement of an arbitrary regulatory intervention. Requiring an undetermined number of plan participants to reallocate their investment elections at a time of sustained market volatility risks subjecting those participants to significant trading risk.<sup>41</sup> As noted in our introduction, we have previously called for this rulemaking to be postponed until well after the pandemic and economic crisis have subsided, and we reiterate that call now.

The Department's analysis of both costs and benefits also stops at the analysis of directly regulated funds, but the reality is that many other types of fiduciaries look to ERISA regulation as guidance.<sup>42</sup> A complete analysis of the costs and benefits on a societal level should reasonably include consideration for these additional stakeholders, even if they do not fall under the direct regulatory oversight of the Department.

It is also worth noting that the proposed rule is wildly out of step with regulatory developments elsewhere around the world. The European Commission is in the midst of a multi-year effort to standardize approaches to sustainable finance, a process that is likely to have ripple effects for financial disclosures among asset managers and corporations alike.<sup>43</sup> In the UK, the new Stewardship 2020 code introduced by regulators requires a statement from asset managers on how they are addressing

---

<sup>40</sup> Coates, John C., IV, and Hubbard, R. Glenn, Competition in the Mutual Fund Industry: Evidence and Implications for Policy, (August 13, 2007). Harvard Law and Economics Discussion Paper No. 592. Available at: [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1005426](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1005426)

<sup>41</sup> At writing, the VIX, an indicator of stock market volatility, has been at or near 5-year highs since late February 2020.

<sup>42</sup> For example, we know that state and local pension systems as well as church plans exempt from ERISA still follow ERISA guidance as broader industry norms.

<sup>43</sup> European Commission, Action Plan: Financing Sustainable Growth, (March 2018), Available at: <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52018DC0097>

systemic risks like climate change.<sup>44</sup> The proposed rule would lead to a pronounced lack of international regulatory consensus that will create significant burdens for all multinational financial services firms, particularly for asset managers raising capital from asset owners in multiple jurisdictions. This effect of the Department's proposed rule will, in particular, harm U.S.-domiciled asset and fund managers that market to ERISA-regulated plans.

When faced with the choice of adopting globally recognized standards of sustainability and risk management or catering to a niche and overregulated market in the United States, we fear that investment managers will choose the former. Those remaining will be forced to charge higher fees to develop ERISA-specific investment strategies, and their performance will be sub-optimized as they willfully blind themselves to material ESG factors. Once more, the anticompetitive nature of the proposed rule will result in fewer and worse performing investment alternatives for participants in ERISA-regulated plans.

The Department also does not seem to have considered the potential ramifications of prohibiting consideration of non-pecuniary factors from a Constitutional law perspective. While we agree that the mandate of ERISA and the Department is and should be the protection of plan participants, the proposed rule wades into unnecessarily fraught issues of protected religious and political speech. Recent rulings from the Supreme Court have found that regulatory mandates on health insurance<sup>45</sup> and mandatory union fees<sup>46</sup> violated different aspects of the First Amendment. It stands to reason then that retirement funds – particularly those with automatic participation – could be subject to the same analysis. The previously discussed effect of the proposed rule to all-but-eliminate the “tie-breaker rule” and the overreaching guidance on QDIA selection could lead to a situation in which a fiduciary's selections would unconstitutionally compel plan participants to participate in political speech.

---

<sup>44</sup> In fact, the introduction of the UK Stewardship Code 2020 says: “Environmental, particularly climate change, and social factors, in addition to governance, have become material issues for investors to consider when making investment decisions and undertaking stewardship.” Available at the Financial Reporting Council:

[https://www.frc.org.uk/getattachment/5aae591d-d9d3-4cf4-814a-d14e156a1d87/Stewardship-Code\\_Final2.pdf](https://www.frc.org.uk/getattachment/5aae591d-d9d3-4cf4-814a-d14e156a1d87/Stewardship-Code_Final2.pdf)

<sup>45</sup> In *Burwell v. Hobby Lobby*, 573 U.S. 682 (2014), Justice Kennedy argues in his concurrence that in meeting “the Government's compelling interest in providing insurance coverage that is necessary to protect the health of female employees” the Department of Health and Human Services must show that, regarding any possible imposition on religious liberty and the Free Exercise Clause, “the means it uses to regulate [is] the least restrictive way to further its interest.” While many plans representing religious institutions are exempt from ERISA as church plans, the Department does not seem to have examined whether or not a significant number of plans exist which would be impacted by this issue. Indeed, the plaintiff Hobby Lobby itself would likely not meet the standard for a church plan, and the *Hobby Lobby* decision explicitly extended this type of religious freedom protection to for-profit corporations.

<sup>46</sup> In *Janus v. American Federation of State, County, and Municipal Employees, Council 31*, No. 16-1466, 585 U.S. (2018) the Court finds that mandatory union fees violate “the free speech rights of nonmembers by compelling them to subsidize private speech on matters of substantial public concern.” One effect of the proposed rule would be to limit the ability of a plan participant to object to the plan's investment in companies that espouse political views in conflict with those of the participant. Crucially in *Janus*, the court found the First Amendment claims compelling even despite objections that the union and union members would be harmed by the decision. So too, one could imagine, it would be difficult to argue that the statutory protections of ERISA outweigh the Constitutional rights of plan participants. At the very least, the Department has not considered how the proposed rule would limit the ability of plan fiduciaries to avoid compelling political speech on the part of plan participants.

By prohibiting plan sponsors from taking steps to allow participants to reasonably assert their rights to religious and political speech, the Department launches an unnecessary foray into Constitutional practice and legal theory that benefits no one apart from the appellate practices of white shoe law firms. The Department should revisit the definition of and restrictions on “non-pecuniary” factors with an eye toward clarifying existing guidance that protects participants without inviting costly legal challenges.

## **Conclusion**

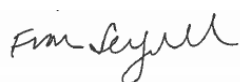
The Alliance has significant concerns with the substance of the proposed rule, and we urge regulators to reconsider some of the foundational assumptions put forth. First, the proposed rule appears to be based on the presumption that ESG factors are often immaterial and lead to underperformance when incorporated into investment strategies. In fact, the opposite is true. The first section of this comment letter presented a non-exhaustive record of academic and industry research that indicate ESG is often financially material, frequently leads to outperformance and helps to mitigate risk and uncertainty over the long-term. The Alliance believes that considering material ESG factors is in alignment with fiduciary duty, and that discouraging such considerations could have harmful effects on plan beneficiaries.

Accordingly, the proposed rule is arbitrarily burdensome for fiduciaries and will produce anticompetitive implications. As we laid out in the second section of this comment letter, there are two specific aspects of the proposed rule that we strongly recommend regulators to reconsider: 1) The proposed rule’s “economically indistinguishable” standard is seemingly an impossible standard to meet. It also effectively eliminates the “tie breaker” process, one that allows for the good faith execution of a plan sponsor’s fiduciary duty and strong protections for plan participants. 2) The proposed rule appears to prohibit the inclusion of any ESG-screened fund from being included as part of the QDIA. This is out of step with the broader investment market and will stifle innovation and competition.

More broadly, the proposed rule creates arbitrary and burdensome double standards for the consideration of ESG factors. This is especially concerning given the evidence provided suggesting that ESG factors are often material and can lead to optimal financial performance. Finally, the Alliance is concerned that the cost benefit analysis of the proposed rule does not properly encapsulate the associated costs and mischaracterizes the benefits, and so we urge regulators to conduct a more rigorous analysis before proceeding.

Beyond our substantive concerns, it is worth reiterating that we are concerned with moving forward with a rule that would have drastic implications for plan fiduciaries and beneficiaries amid a global pandemic and economic upheaval. In fact, the ongoing crises we are facing today only reinforce the importance of considering long-term material ESG factors in investment decisions. In closing, we call on regulators to suspend this rulemaking until well after the COVID-19 crisis has been resolved. Thank you for the opportunity to provide comment.

Sincerely,



Fran Seegull  
Executive Director, U.S. Impact Investing Alliance