PUBLIC SUBMISSION

Received: July 21, 2020
Status: Pending_Post
Tracking No. 1k4-9hxt-d2e4
Comments Due: July 30, 2020
Submission Type: API

Docket: EBSA-2020-0004
Financial Factors in Selecting Plan Investments

Comment On: EBSA-2020-0004-0002
Financial Factors in Selecting Plan Investments

Document: EBSA-2020-0004-DRAFT-0261
Comment on FR Doc # 2020-13705

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General Comment

I cannot say it better than Jon Lukomnik and at least 30 other experts in the field.

Attachments

Comment Letter on Proposed Regulation of ESG Standards in ERISA Plans

Comment Letter on Proposed Regulation of ESG Standards in ERISA Plans

Posted by Jon Lukomnik, Sinclair Capital, LLC, on Tuesday, July 21, 2020

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Tags: DOL, Environmental disclosure, ERISA, ESG, Institutional Investors, Retirement plans, Securities regulation, Shareholder value, Stewardship, Sustainability, Systemic risk
More from: Jon Lukomnik

Editor's Note: Jon Lukomnik is Managing Director of Sinclair Capital, LLC. This post is based on his comment letter submitted to the Department of Labor, with input from Keith Johnson and signed by 30 people, including various experts in the field. Related research from the Program on Corporate Governance includes The Illusory Promise of Stakeholder Governance by Lucian A. Bebchuk and Roberto Tallarita (discussed on the Forum here) and Reconciling Fiduciary Duty and Social Conscience: The Law and Economics of ESG Investing by a Trustee by Robert H. Sitkoff (discussed on the Forum here).

To Whom It May Concern:

We are writing in opposition to proposed rule RIN 1210-AB95. We believe the rule is not only unnecessary, but

1. Is based on a woefully incorrect understanding of the current state of investing knowledge and theory,
2. Endangers the retirement security of Americans rather than protects it,
3. Is Internally inconsistent,
4. Applies an inadequate analysis of ERISA fiduciary duties by ignoring the duty of impartiality, and
5. Would violate Federal cost-benefit regulations.

The proposed rule is based on a woefully incorrect understanding of the current state of investing knowledge and theory: An "eye singular" towards retirement security is not the same as encouraging willful blindness.

The major goal of investing for retirement is to create a desirable risk/return portfolio over time, so as to offset retirement expenses. As the Department of Labor wrote in the background to the rule, "Courts have interpreted the exclusive purpose rule of ERISA Section 404(a)(i)(A) to require fiduciaries to act with "complete and undivided loyalty to the beneficiaries," The Supreme Court as recently as 2014 unanimously held in the context of ERISA retirement plans that such interests must be understood to refer to "financial" rather than "nonpecuniary" benefits… plan fiduciaries when making decisions on investments and investment courses of action must be focused solely on the plan's financial returns and the interests of plan participants and beneficiaries in their plan benefits must be paramount."

We agree. The question is how is that best accomplished. Surely plan fiduciaries must, as the proposed regulation says, consider expected risk and return, as well as characteristics such as liquidity and volatility. Hence the fiduciary duty of care and the duty of loyalty, as well as adherence to the fundamental trust law legal principle, recognized in §227 of the *Restatement (Third) of Trusts*, that: "Trust investment law should reflect and accommodate current knowledge and concepts. It should also avoid repeating the mistake of freezing its rules against future learning and developments." New investment approaches cannot be rejected just because they are different, yet the proposed rule consistently uses a dated "status quo ante" bias.

Traditional investing, as typically considered under the rubric of Modern Portfolio Theory (MPT), uses diversification to mitigate risk. The Department endorses, and even requires, such risk mitigation. Again, we agree with the Department that such diversification is prudent and necessary. However, there are limitations to the risk mitigation ability of diversification. It works on idiosyncratic risk; the risk of stock A combined with stock B, or on bond X and bond Y.

However, the vast majority of return is related to systematic risk and return in the marketplace, not to security selection or portfolio construction. Accepted academic literature shows that 75-95% of variability in return is caused by non-diversifiable systematic factors. Traditional investing using MPT and relying on diversification of idiosyncratic risk, cannot, and does not pretend to, mitigate such systematic risks.

This is the advantage of adding an ESG lens atop traditional investing. By seeking to accept or avoid systematic opportunities or risks respectively, and, even more importantly, by seeking to mitigate systematic risks *ESG provides an additional risk control tool to investors above and beyond the risk mitigation available through diversification.*

It is this risk mitigation aspect of using an ESG lens to examine the systematic risk factors which affect investments that makes ESG so valuable. It is also why the proposed DOL rule is so dangerous. Rather than suggesting that plan fiduciaries use all available ways to create a desirable financial return profile for potential ERISA plan investments (which would be consistent with the fiduciary duty of care), the rule would force plan fiduciaries to turn a blind eye to the most proven and effective way to mitigate systematic risk, and only to ESG. That is not an "eye singular" to financial return. It is willful blindness.

The proposed rule actually endangers the retirement security of Americans.

ESG-based investing has outperformed traditional benchmarks. There is a reason for this: The capital markets reflect value creation/destruction in the real economy. One meta review of approximately 2200 studies of corporate performance found that 63% of them associated better ESG performance with higher value creation (only 8% had negative findings). Other studies suggest that high performing ESG companies create value disproportionate to their peers: "ESG links to cash flow in five important ways: (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", according to a study published in the November 2019 McKinsey Quarterly. ESG affects not only the equity of those companies, but also their debt. ESG performance correlates with material events and credit risk, as measured by bankruptcies and credit spreads, which has major implications for credit markets and bond investors. Those results were published in a peer-reviewed Journal of Applied Corporate Finance article.

ESG investing can also be less risky (as manifested by volatility of returns) during major market dislocations. A number of recent studies examined the volatility of the equities of various companies and found that the stocks of more sustainable companies faired less worse than a benchmark group during the initial market reaction to the COVID-19 pandemic.

Indeed, we would suggest that, based on the desire for an "eye singular" to the financial returns of ERISA plan investments, any fiduciary who does not consider ESG is violating his/her duty of care. Yet the proposed rule would explicitly prohibit the use of ESG-integrated investments as a Qualified Default Investment Alternative (QDIA).

This is a proposed regulation gone topsy-turvy. First the Department encourages fiduciaries to use blinders by discouraging an accepted risk mitigation technique, then forbids using such investments as a QDIA if a fiduciary can prove, even under the hurdles the proposed rule would create, that such investments are superior in terms of risk/adjusted financial performance.

We note that this is directly contrary to the evolution of regulation in other markets and the evolution of the capital markets themselves. Jurisdictions around the world are mandating requirements exactly oppositional to the direction of the Department of Labor's proposed regulation. As the European Commission wrote explaining its recent decision to consult about strengthening ESG disclosures: "Users of this information, mainly investors and civil society organisations, are demanding more and better information from companies about their social and environmental performance and impacts. To this end, the Commission committed to review the Non-Financial Reporting Directive in 2020 as part of the strategy to strengthen the foundations for sustainable investment." In the United Kingdom, that jurisdiction's new Stewardship 2020 code requires a statement from asset managers of how they are dealing with systemic risk. As a result, considering ESG risk factors has become a de facto standard for asset managers in the EU and other developed nations, where regulators clearly believe such an investment lens drives greater risk/return efficiency and provides more transparency.

Perhaps more importantly, the global capital markets are also signaling that ESG investing is mainstream. The capital markets understand the numbers: Considering ESG risks and opportunities improves rather than hinders the risk/return profile of investments. Therefore, some $40 trillion in assets under management globally now is managed using an ESG focus. The worlds' largest asset manager, Blackrock, has called for more ESG disclosure and for making climate change core to its investment philosophy. The world's largest pension fund, GPIF in Japan, has adopted ESG as a core investment philosophy. That capital market evolution towards, not away from, ESG integration continues apace. Some $400 billion in sustainable debt was issued in 2019, and the pace of issuance in 2020 is even faster. Yet, the proposed regulation prohibits, absent extraordinary effort, plan fiduciaries from selecting investment products which control approximately 40% of all capital market assets or to invest in such bonds, and to prohibit it altogether for QDIAs.

While the United States Department of Labor is, of course, free to assert exceptionalism from other jurisdictions, we suggest that being this out of step with trends in global investment regulation and with the capital markets should give the Department pause.

In fact, were the Department to be consistent with both its desire to emphasize financial returns and the duty of care of fiduciaries, the rule should be turned upside down: Plan fiduciaries should be required to consider **all** factors which affect risk and return, or justify why they do not. As a corollary, only investment programs which consider all material risk/return factors, including ESG, should be considered for QDIA status. We remain mystified as to why the Department would require attention to diversification and liquidity risks, but carve out ESG risks which relate to the systematic factors that dominate investment returns.

The proposed rule is internally inconsistent.

The proposed rule states, several times, that ESG factors may be considered if "qualified investment professionals would treat (them) as material economic considerations under generally accepted investment theories." Yet, as noted earlier, academicians believe ESG is economically material, regulators in other jurisdictions believe ESG to be economically material, and some $40 trillion already is managed with ESG considerations, which is a material subset of the entire global capital market. That is, in our opinion, dispositive evidence that many "qualified investment professionals" consider ESG factors "as material economic considerations under generally accepted investment theories."

Given the proposed rule's acceptance of the opinions of qualified investment professionals as to what constitutes economic materiality, and given the fact pattern cited above, we believe a reasonable person would presume ESG de facto constitutes materiality. Yet the proposed rule does the opposite, and forbids consideration of ESG-integrated investment products as a QDIA.

The proposal uses an inadequate analysis of ERISA fiduciary duties by ignoring the duty of impartiality

The proposal fails to acknowledge the ERISA fiduciary duty of impartiality. Impartiality requires that fiduciaries recognize that different classes or groups of plan participants often have interests which may conflict or diverge from each other. Fiduciaries must undertake good faith efforts to reasonably balance those differences. For example, younger and older participants are likely to have differing investment risk tolerances, income generation needs and long-term capital growth expectations. By defaulting to a short-term bias, the proposal downplays materiality of ESG/sustainability risks and opportunities (e.g., those associated with climate change, misaligned executive compensation plans, workforce mismanagement, human rights violations, corporate culture, etc.) to which long horizon ERISA investors are exposed, even though they might not be evident in short-term financial metrics. This is a fatal flaw.

The US Supreme Court recognized that the duty of impartiality applies to ERISA fiduciaries in *Varity v. Howe,* 516 U.S. 489 (1996). It said, "The common law of trusts [made applicable to ERISA §§404, 409] recognizes the need to preserve assets to satisfy future, as well as present, claims and requires a trustee to take impartial account of the interests of all beneficiaries. See Restatement (Second) of Trusts § 183 (discussing duty of impartiality); *id.,* § 232 (same)."

The one-size-fits-all, short-term approach taken in the proposal mischaracterizes the duty of ERISA fiduciaries by ignoring the obligation to impartially seek a fair balance to short- and long-term interests of younger and older, as well as current and future, plan participants. By discouraging consideration of ESG factors (many of which have material long-term financial consequences) the proposed rule seems likely to pull deployment of pension assets away from sustainable future wealth building toward generation of current returns while deferring risks into the future. This is likely to unfairly sacrifice the long-term economic interests of younger fund participants, while adding pro-cyclical dynamics to the US economy that will create a drag on long-term returns. It seems especially problematic to categorically exclude investment options which consider what might be categorized as sustainable investment factors as part of an established strategy focused on generation of longer-term, risk-adjusted returns for younger fund participants.

The proposed rule would violate Federal cost-benefit regulations.

The proposal blithely notes the "Department estimates that this requirement would not result in a substantial cost burden". The only reason the department can make such an erroneous assertion is because the only costs considered are the documentation mandate of the proposed regulation.

The cost/benefit analysis is as flawed as the basic misunderstanding of ESG. First, the Department makes unproven, undocumented and wrong statements that ESG-integrated mandates will cost more than non-ESG mandates. That is just wrong. For example, as of July 5, 2020, The ACWI exchange traded fund, which tracks the ACWI equity index, had a net expense ratio of 32 basis points. The CRBN exchange traded fund, which also tracks the ACWI equity index but with a lower carbon footprint, had a net expense ratio of 20 basis points. Both are part of Blackrock's iShares family of ETFs.

Perhaps more importantly, the assumptions about cost benefit neglect the opportunity cost of foregoing ESG risk analyses, and of plan fiduciaries being able to either avoid risk or seize opportunity as a result of those analyses. For example, the proposed rule would also seem to prohibit fiduciaries from spending plan assets to address systematic ESG risks, even though the potential benefits to such actions are material and, in many cases studied, far greater than the unproven, undocumented (and fictitious) costs the proposed rule suggests ESG activities cause.

As an example, consider the Boardroom Accountability Project undertaken by the New York City Comptroller, on behalf of the New York City retirement systems, in 2014. Comptroller Scott Stringer announced that he would seek to create a "proxy access" rule at 75 companies through private ordering, following a convoluted history of the SEC attempting to create such a rule only to be precluded by the courts. The mere announcement caused a 53 basis point excess return, according to three academics, including one from the SEC. At the time of Comptroller Stringer's announcement, the City's funds held $5.023 billion in those 75 companies' stock. Based on the 53 basis points of excess return, that means the BAP created some $266 million in excess return for the City's pension funds. As the City's funds generally hold 1% or less of a company's stock, that means the total market impact was more than $25 billion. The actual impact on total market value over time, as 600 companies have adopted proxy access is likely even greater. While the academic study noted that the results likely would have been greater had a proxy access standard been market-wide and set by regulation, even just using the 53 basis point as the basis, extending the attempt to install proxy access across every listed company at the time of Stringer's announcement would have resulted in an increased market value of some $132.5 billion.

To summarize, the proposal's assumption of increased cost to ESG investments is undocumented and fictitious. On the benefit side, it ignores the proven efficacy of ESG activities in causing markets to rerate due to a decrease in systematic risk, and that rerating is worth billions in increased retirement savings.

Conclusion

The Departments' proposed regulation is wrong in its assumptions about what ESG is, wrong about the cost of the proposed regulation, would impoverish Americans saving for retirement, is out of step with both foreign regulators and the capital markets, ignores facts about ESG performance, is wrong about costs of ESG products, ignores the pecuniary benefits of ESG products to plan fiduciaries, would cause plan fiduciaries to violate their duty of care by placing an impost to their examination of systematic risks and opportunities which will determine 75%-95% of return, and ignores the duty of impartiality.

These are informed and considered conclusions. The undersigned have, in combination, the following current or former experience and expertise relating to retirement savings

- Trustees for more than $200 billion in retirement savings, including being a fiduciary for ERISA plans
- Administrator of the PBWA, the predecessor to EBSA
- Relevant academic appointments in Business, Economics, Finance, Law and Management at: Brown University, University of California (Davis), Judge Business School of Cambridge University, Columbia University, Harvard Business School, Harvard Law School, IAE Aix-Marseille Graduate School of Management, Marlboro College, Smith School of Business Maryland University, Stern School of Business New York University, University of Oregon Law School, Said Business School of Oxford University, Wharton Business School of the University of Pennsylvania, The University of Paris, Rutgers University Business School, University of South Carolina, St. Mary's of California, the University of Wisconsin, and Yale School of Management.
- Written seven peer-reviewed academic books and edited another.
- Written more than 1600 academic and practitioner papers related to retirement savings, investing and the capital markets.
- Written or edited more than 20 relevant trade books
- Trustee on 40-act mutual funds, insurance trusts, and European UCITS funds
- Leadership positions at global asset management firms
- CEO of an ESG data company serving clients with cumulative AUM of $14 Trillion
- Ten years as the executive director of a leading think tank on capital market issues, overseeing nearly 80 academic and practitioner research projects related to the subject area.
- Head of research at an artificial intelligence firm, focusing in large part on ESG issues.
- President of a national pension fund attorneys education association.
- Chair of the Academic Advisory Committee of the United Nations Principles for Responsible Investing

We strongly urge the Department to withdraw the proposed rule and to replace it with a rule more consistent with evidence: That only investment options which consider ESG risk can be considered for QDIA status.

Sincerely,

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Bill Baue, Senior Director, r3.0 (Redesign for Resilience & Regeneration); Senior Advisor, Preventable Surprises

Richard A. Bennett, President and CEO, ValueEdge Advisors

William Burckart, President, The Investment Integration Project; Fellow, High Meadows Institute

Stephen Davis, Associate Director and Senior Fellow, Harvard Law School Programs on Corporate Governance and Institutional Investors; former member of the SEC Investor Advisory Committee

Debra Dunn, B Lab Board Member

Robert G. Eccles, Visiting Professor of Management Practice, Said Business School, University of Oxford; Founding Chairman, Sustainability Accounting Standards Board; Senior Advisor, Impact Management Project

Jed Emerson, Founder, Blended Value Group

Amanda Feldman, Impact Advisor, Predistribution Initiative

Caroline Flammer, Associate Professor, Boston University

Susan Gary, Professor Emerita, Orlando John & Marian H. Hollis Chair, University of Oregon Law School; Reporter, Uniform Prudent Management of Institutional Funds Act, Uniform Law Commission

Aline C. Gatignon, Assistant Professor of Management, The Wharton School, University of Pennsylvania

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Jared Meyers, Founder & Chairman, Legacy Vacation Resorts; Salt Palm Development

Nell Minow, Vice Chair, ValueEdge Advisors

Robert A. G. Monks, Chair, ValueEdge Advisors; Former head of EBSA's predecessor (PWBA – Reagan Appointee)

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