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July 27, 2020

Re: Department of Labor Proposed Rule RIN 1210-AB95

Late last month, noting its concern

> *"that the growing emphasis on ESG investing may be prompting ERISA plan fiduciaries to make investment decisions for purposes distinct from providing benefits to participants and beneficiaries and defraying reasonable expenses of administering the plan,"*

the U.S. Department of Labor (the "Department") proposed a new rule to further clarify its stance on the use of environmental, social and governance ("ESG") criteria in selecting investment options for ERISA-governed retirement plans. The Department has provided guidance on ESG investing for more than 25 years, but this particular rule has sent a shockwave through the retirement plan marketplace since ESG monitoring, as part of the investment management process, has seen significant adoption among many fiduciaries and professionals.

While we believe that there are some fundamental and fatal flaws in the Department's proposal which we discuss below, what many misunderstand about this rule is that it permits plans to use ESG as a core fund menu investment, but it forbids ESG-based funds as qualified default investment alternatives ("QDIA") - or any component of them.

At the heart of the debate is whether ESG factors have a pecuniary (monetary) value to investors or not. If ESG investing can provide benefit to beneficiaries, it is appropriate to use. If no advantage accrues for the benefit of participants compared to traditional funds, then an ESG overlay would not be prudent. The Department's stance on QDIAs makes clear its negative feelings towards ESG investing even though there is literature available showing that ESG screens are, at worst, not harmful and in some cases can be additive to long-term performance.

Part of the issue is caused by the misguided definitions and politicization of this investment process by the Department and the financial industry as a whole. ERISA states that investment decisions must be made in the best interest of plan participants and beneficiaries. If ESG mandates are intended to be used as a form of social engineering or to drive a social objective at the expense of returns, that conflicts with established ERISA standards. If used as an evaluation tool like other metrics with the objective of enhancing return or reducing risk, then it can be considered prudent.

For qualified plan money, incorporating ESG language into Investment Policy Statements is permissible if the criterion is used like other metrics in the document to help enhance returns or reduce risk of the investment option. Cornerstone is very much in favor of doing well by doing good and looks to hire managers who are excellent stewards of the assets under their care.

We outline some of the shortcomings we see in the proposed rule below and would ask the Department to reconsider its stance on this matter.

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“Various terms have been used to describe this and related investment behaviors, such as socially responsible **investing, sustainable and responsible investing, environmental, social, and corporate governance (ESG) investing, impact investing, and economically targeted investing. The terms do not have a uniform meaning and the terminology is evolving.”**

The Department acknowledges that the terminology around these investments is evolving; however, it does not indicate that socially responsible investing, ESG investing, impact investing, etc. would only be loosely grouped even if there was a widely accepted terminology. They are different theories on how to allocate assets, not a type of investment and are only tangentially connected depending on a fiduciary’s definition of each.

Most adherents of ESG look at it as a way to mitigate long-term risks in order to enhance returns. Whereas an impact investor may allocate resources to a good cause and accept a lower return to promote a social issue[1], few, if any, ESG investors would accept such a proposition.

These arguments are not to suppose that all ESG processes are created equally or marketed ethically. They are not; however, these potential issues should be regulated by the Securities and Exchange Commission (“SEC”) rather than the Department.

“The Department further emphasized in FAB 2018-01 that fiduciaries must not too rea**dily treat ESG factors as economically relevant to the particular investment choices at issue when making a decision,”**

This statement is tone deaf in the current era of “cancel culture”, “company shaming” and customer pressure. Corporations across the world are acknowledging that they must serve their stakeholders (their workers, their customers, their communities) in order to maximize value for their shareholders. ESG has not been perfect in detecting corporate malfeasance, but it has helped some investors avoid losses associated with it.

While one might argue that a traditional socially responsible investment might exclude certain industries, this is not necessarily true of managers with an ESG overlay. We would expect any manager to invest in the “best” companies in an industry if the outlook for that industry warrants an investment. If, however, investors want to limit their exposure in the energy sector to those companies that have the best renewable energy programs because the risk of fossil fuels over the coming decades seems steep and the return potential is better to “go green” in their estimation, we do not understand where the Department has standing to judge that decision. The market will decide the winners and losers, not anyone of us sitting here looking prospectively.

[1] For another time is the discussion regarding how impact investing and economically targeted investing are maturing and becoming competitive investments: see Green Bonds.

"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, despite featuring prominently in marketing efforts."**

This statement is largely correct but lacks any indication of nonpecuniary benefits and shortly thereafter mentions that the SEC is currently looking into this issue. The Department should not front run those examinations.

One of the issues surrounding ESG is that it is still maturing as an investment process. There is no standard database to evaluate ESG performance. Morningstar, MSCI and others have different measurements of ESG, Stewardship and Sustainability.

If the point of this statement is to say that investors may not understand what they own, one could argue that participants do not fully understand their current passive funds options because there exist various index providers that base benchmark inclusion on different factors (see Standard and Poor's, Frank Russell, etc.) For example, participants heavily invested in a Russell 1000 Growth fund are unlikely to know that almost 30% of that position is comprised of 3 individual companies.

"Moreover, ESG funds often come with higher fees, because additional investigation and monitoring are necessary to assess an investment from an ESG perspective."

The supporting documents for this statement are questionable at best. Comparing the cost of a passive large cap domestic stock index fund to a universe of ESG funds is misleading. ESG is not an investment, it is a process. ESG can be applied to small cap stocks, international stocks, bonds, alternative investments, etc. which all also carry higher costs than an S&P 500 index fund.

If looking purely at passive investments, the difference in cost between traditional funds and funds with an ESG mandate is based on the law of large numbers. As funds with ESG overlays become more prevalent, the cost associated with them will fall because the fixed costs of compliance and operations will be spread over a larger investment base.

"(T)he environmental, s**ocial, corporate governance, or similarly oriented alternative is not added as, or as a component of, a qualified default investment alternative"**

The disqualification of ESG as a part of a QDIA clearly indicates that the Department is against the idea of ESG without regard to outcomes-based studies stating that these processes generally do not harm investors. We acknowledge the Department's stance that QDIAs carry with them a higher fiduciary risk, but this language indicates that any fund that utilizes ESG in their investment mandate would be unworthy of inclusion.

The functional problem with this portion of the proposed rule is that many investment managers currently use some sort of ESG criteria – even if they do not explicitly say that they do. For example, the Department's proposed rule would disqualify the American Funds Target Date Series as a QDIA because the Washington Mutual Investors Fund is an underlying fund and specifically screens out alcohol and tobacco products[2]. As we see it, these target date funds have a track record of providing superior performance at reasonable fees to plan participants. If implemented strictly, only a few of the massive index investors would be eligible to manage target date funds, creating monopolistic pricing power amongst them.

In summary, politicizing the retirement readiness and safety of Americans is wrong regardless of which side of the aisle you sit. While the Department ends this proposed rule in the right place – a fiduciary must always put the best financial interests of its beneficiaries first – it spends a lot of ink disparaging the idea of utilizing non-traditional research such as ESG without truly explaining its thinking, and in some cases even ignoring academic studies showing the pecuniary benefit to investors of investing for good. There are also vast unintended consequences to fiduciaries and beneficiaries alike arising from this proposed rule – for example, has there been a discussion on whether offering investments that align with a participant's moral code could increase participation rates? There is a lot to these conversations that this proposal does not address. For these reasons, we believe that this proposed rule should be withdrawn.

Regards,

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[2] Please see Summary: https://www.capitalgroup.com/advisor/investments/fund/wmffx