1629 K Street, NW, Suite 300
Washington, DC 20006

July 28, 2020

Office of Regulations and Interpretations
Employee Benefits Security Administration
Room N-5655
US Department of Labor
200 Constitution Avenue, NW
Washington, DC 20210

RE: Proposed Rule on Financial Factors in Selecting Plan Investments (RIN 1210-AB95)

Dear Employee Benefits Security Administration:

I write in strong opposition to the Department of Labor's proposed rule, "Financial Factors in Selecting Plan Investments" (RIN 1210-AB95) (the "Proposal"). I serve as Managing Principal of SRI Group LLC, a consultancy focused on responsible investing in retirement plans. Prior to SRI Group, I served as an ERISA fiduciary and co-chair of two investment committees for the bank trustee for the Multi-Employer Property Trust, a multi-billion-dollar bank collective investment trust investing for public and union pension plans. I have also worked as a senior officer with the AFL-CIO Housing Investment Trust and AFL-CIO Investment Trust Corporation servicing the AFL-CIO Building Investment Trust. During my tenure, these organizations prudently applied responsible considerations to billions of dollars of investments for pension plans. Although this experience informs my comments, my current affiliation is only with SRI Group LLC and these comments are not made on behalf of any other organization.

The Proposed Rulemaking is Arbitrary and Capricious in Undermining the Central Purpose of ERISA

The Employee Retirement Income Security Act of 1974 was adopted to protect retirement savers by setting high standards for retirement plan fiduciaries, requiring them to act with due care, skill, prudence, and diligence and to avoid conflicts of interest. The ultimate purpose of ERISA is to maximize retirement savings for plan participants.

There is overwhelming evidence from both academic and industry sources that responsible investments that take into consideration environmental, social, and governance (ESG) factors generally perform as well or better than conventional investments.

For example, the US Government Accountability Office reviewed five years of rigorous, peer-reviewed academic studies and reports and concluded: "The vast majority (88 percent) of the scenarios in studies we reviewed … reported finding a neutral or positive relationship between the use of ESG information in investment management and financial returns in comparison to otherwise similar investments."[1] The GAO report also referenced meta-studies by other researchers surveying the relevant academic literature that reached the same conclusion.[2]

Morningstar, a leading investment industry research organization, reviewed 303 funds available in 2019 across a full range of asset classes that focused on ESG considerations.[3] The report found that 65% of these funds performed in the top half of their relevant peer groups on a one-year basis, 67% on a three-year basis, and 64% on a five-year basis. Only 14% performed in the bottom quartile on a one-year basis, 12% on a three-year basis and 13% on a five-year basis.

Morningstar has updated these findings with a recent report showing exceptional performance by ESG-guided funds through the recent market volatility resulting from the corona virus pandemic.[4] Although past performance does not guarantee future performance, what is clear is that there is no empirical basis for assuming or concluding that ESG-guided investments generally underperform conventional investments. The overwhelming evidence so far is to the contrary.

The proposed rulemaking narrowly targets responsible, ESG-guided investment for burdensome and intrusive regulation and oversight, openly designed to obstruct and discourage such investment within retirement plans. If this type of burdensome and intrusive oversight were really needed to protect plan participants, it would be applied across a full range of investment strategies, including many active investment strategies commonly employed in ERISA-governed investments with mixed performance track records. Instead it is being narrowly targeted to obstruct one type of investment with an exceptional performance track record.

In these proposed regulations, the DOL is attacking a fictitious problem – the supposed trade-off between ESG considerations and investment performance. As noted, the overwhelming evidence from academic and industry sources is that no such trade-off exists. Consequently, by discouraging and deterring fiduciaries from investing in ESG-guided funds, the DOL would be forcing participants into potentially lower-performing investments resulting in lost, long-term retirement savings, in direct contravention of ERISA's purpose.

For these reasons, the proposed rulemaking is arbitrary and capricious in that it undermines ERISA's central purpose.

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[1] Government Accountability Office, *Retirement Plan Investing: Clearer Information on Consideration of Environmental, Social, and Governance Factors Would be Helpful* (May 2018), 7-8. Available at: https://www.gao.gov/assets/700/691930.pdf

[2] Ibid.

[3] Morningstar, *Sustainable Funds U.S. Landscape Report: Record Flows and Strong Fund Performance in 2019* (February 2020) ("*Morningstar 2019 Landscape Report*"). Available at https://www.morningstar.com/lp/sustainable-funds-landscape-report?con=15987&cid=CON_RES0061

[4] Morningstar, *Sustainable Funds Weather the First Quarter Better than Conventional Funds* (April 2020) available at: https://www.morningstar.com/articles/976361/sustainable-funds-weather-the-first-quarter-better-than-conventional-funds

The DOL's attack on the "all things being equal" test breaks with decades of precedent and has no basis in the reality of investment decision-making

For decades, the DOL has allowed, through official guidance, investment fiduciaries to consider non-financial "collateral benefits" in choosing among investments offering a comparable risk and return profile. All things being equal, a collateral benefit, including an ESG consideration, can be used as a tiebreaker. Stated differently, fiduciaries can choose an investment providing an ESG benefit – even if that benefit cannot be demonstrated to be economically material – if doing so does not result in any discounting of anticipated risk-adjusted investment returns.

The DOL now proposes to narrow essentially to nothing the circumstances under which the "all things being equal" test can be applied. Under the proposed rule, to be considered comparable from a risk/return perspective, investments must be "economically indistinguishable" – a new standard never before used. Further, any fiduciary who uses the "all things being equal" test must formally document why the investment was determined to be economically indistinguishable – an intentionally burdensome procedure for a fiduciary and one that heightens exposure and risk for a fiduciary in an enforcement context. And, just in case a fiduciary did not get the message, the DOL states in its narrative accompanying the proposed rulemaking: "The Department expects that true ties rarely, if ever, occur." Fiduciaries are on notice that this is the attitude that the DOL will bring into investigations and enforcement.

But the DOL's underlying premise is wrong. Investment analysis used for investment selection is forward-looking and, as such, is imprecise. It is simply impossible to precisely forecast investment return and volatility. Because of this inherent imprecision, significant classes of investments can appropriately be determined to present a comparable risk and return profile on a forward-looking basis for portfolio management purposes. It is vastly overstating the predictive power of forward-looking investment analysis to suggest that investments must be "economically indistinguishable" to present a comparable risk/return profile.

As a simple example, the stocks of two companies could properly be determined by a portfolio manager to present a comparable risk/return profile. The companies might be in the same industry or in the same region or have the same customer base or have the same basic capital structure or any of many possible common characteristics or combinations of characteristics. A portfolio manager cannot forecast precisely how each stock will perform but nevertheless could properly place them in the same risk/return category for portfolio management purposes and make prudent investment decisions accordingly. What is certain, however, is that the stocks will not be "economically indistinguishable" because they will be the stocks of different companies which inevitably will have different, economically relevant characteristics ranging from product mix, to debt load, to market capitalization, to governance, to workforce, to liquidity and so on.

The elimination of the "all things being equal" test would be consequential, as the drafters of the proposed regulation are well aware. If the new regulation is adopted, fiduciaries would only be allowed to consider an ESG factor if it could be demonstrated that that factor <u>improved</u> forecasted financial performance. This departs from decades of precedent that allowed fiduciaries to consider ESG factors

so long as doing so did not discount expected financial performance. This change would tip the burden of proof that fiduciaries must meet sharply against ESG investments, increasing fiduciary jeopardy in enforcement actions and deterring fiduciaries from considering them.

By proposing to require fiduciaries to demonstrate and document that investments being considered for the purposes of the "all things being equal" test are "economically indistinguishable," the DOL is knowingly offering fiduciaries a bridge to nowhere. This rejection of past precedent and guidance has no basis in ERISA or in the realities of investment decision-making. It is arbitrary and capricious.

The "Economically Materiality" Test Proposed by the DOL is Extraordinarily Burdensome and Not Grounded in the Reality of Investment Decision-Making

The proposed rules would require a fiduciary who applies an ESG factor in investment selection to demonstrate that the individual factor would be treated as a material economic consideration by "qualified investment professionals … under generally accepted economic theories."

This new rule would allow the DOL to micro-analyze through investigations and enforcement every investment decision by an ERISA fiduciary *that involved an ESG consideration* by demanding a rigorous materiality showing for every ESG factor considered.

This proposed regulatory approach is extraordinarily burdensome and discriminatory against ESG investments – a class of investments that, ironically, has an exceptionally good performance track record. The approach is unnecessary to protect plan participants, but assuming that it was necessary, it should be applied to active investment strategies of every type. Many funds and strategies, long accepted in ERISA-regulated plans, apply a variety of factors in stock selection. Generally, these factors are considered proprietary to the manager. The historical performance track records of many of these strategies and actively managed funds are, at best, mixed relative to the relevant peer groups. If the DOL believes it is necessary for the protection of participants for fiduciaries to have to demonstrate the economic materiality of every investment selection criteria used in ESG investing, that policy should be applied across the board to all investments. Active managers of all types should be expected to defend each of the factors they use in selection with a rigorous demonstration of economic materiality as determined by hypothetical investment professionals applying "generally accepted investment theories."

However, the DOL's proposed economic materiality test should not be applied to any investments – ESG or conventional – because it is wrong and fundamentally misunderstands the investment selection process. The best investment professionals do not always base their decisions on what is "generally accepted" by other investment professionals. That is how they are able to outperform their peers. The notion that there is a typical group of "qualified investment professionals" applying a common definition of economic materiality that could be the basis for a legal standard is simply wrong and the DOL provides no evidence that such a typical group or common definition exists.

The DOL provides no real-world information as to what would be considered "generally accepted investment theories." Is this a reference to Modern Portfolio Theory which, despite its name, is now nearly 70 years old? Does it include so-called Post-Modern Portfolio Theory introduced in the 1990s

or more recent liability-driven and risk-based portfolio management approaches? Few, if any, portfolio managers mechanically follow any given academic investment theory in actual practice. And there is no "generally accepted" investment theory that most or all portfolio managers or other investment professionals follow. Certainly, the DOL provides no empirical evidence that such generally accepted investment theories exist, much less what they are. And yet, the DOL proposes to use such hypothetical investment theories as the basis for a legal standard to be applied in ERISA investigations and enforcement.

In any event, real world investment judgments by qualified investment professionals are not always grounded in considerations that can be rigorously proven to be economically material no matter what investment theory underlies the definition of material. Many such judgments by investment professionals involve educated guesses about the future based on their experience with markets and investments. The ability of the best investment professionals to make those judgments is why their clients hire them.

One thing that should be clear from the above comments is that the DOL does not have the knowledge at the investigator level or management level to micro-analyze and second-guess individual investment decisions by portfolio managers. This is not a criticism of the professionals at the DOL. No regulatory body, regardless of how staffed, could successfully carry out an investigation and enforcement program at this micro-level. The concern is that this may be part of the design. Applying the proposed regulatory standard for economic materiality to each use of an ESG factor in investment decision-making will lead to such uncertainty, confusion and perceived risk by fiduciaries that they will avoid ESG investing altogether.

Selectively targeting ESG investments for unnecessary micro-analysis by DOL investigators and enforcement personnel based on a faulty standard is discriminatory, without foundation in ERISA or real-world investment practice, and, therefore, arbitrary and capricious.

The Proposed "Economic Materiality" Test Excludes Persuasive Explanations for the Strong Performance Track Record of Responsible Investments that Investors Should be Allowed to Consider

Some ESG considerations involve obvious risk factors and possibly would be allowed under the DOL's proposed regulation. A company with a particularly poor environmental track record may reasonably be deemed to pose an outsized financial risk due to the greater likelihood of an expensive environmental accident or regulatory enforcement action.

However, the DOL's proposed regulatory approach to ESG investing – that is, examining individual ESG factors for economic materiality – excludes a number of persuasive explanations for why responsible, ESG-guided investments generally perform as well or better than conventional investments. These are explanations that investment professionals can, should, and, in fact, do take into consideration:

- Companies that manage their ESG impacts well tend to be better managed overall and therefore perform better financially – whether or not each ESG impact being managed can individually be proven to be economically material.
- Companies with strong ESG track records tend to be viewed more favorably by their own employees and customers whether or not the relevant ESG considerations themselves can be proven to be economically material. Employee and customer attitudes are extremely important drivers of corporate success.
- Companies that pay attention to ESG factors tend to have a longer-term perspective and strategic view than companies that do not. Such a longer-term perspective may extend beyond the time horizon for a standard financial analysis and therefore involve considerations that might not be deemed "economically material." However, events may be moving faster than anticipated by standard financial analysis or "generally accepted investment theories" – as has consistently been the case for climate change impacts, for example. A company that is prepared for the long-term may, in fact, be better able to navigate the unexpected in the near-term – and perform better financially.

This raises the deeper question of what is meant by "economic materiality?" Does it mean a factor that an accountant would find material and therefore reflect in a financial statement? Does it mean a factor that an investment analyst reading a financial statement would find material and therefore reflect in his or her report or recommendation? The reality is that accountants and investment analysts only secondarily determine investment value and investment return, at least for publicly traded investments. The final arbiters of value are investors who notoriously can and often do ignore financial data and invest based on their expectations regarding the future, even if those expectations are grounded in emotion or intuition.

According to a recent Harris Poll survey, 80% of Americans agreed that the corona virus pandemic "has opened my eyes to acceptable and unacceptable corporate behavior," and 89% agreed that the pandemic "is an opportunity for large companies to hit 'reset' and focus on doing right by their workers, customers, communities and the environment."[5] These are extraordinary levels of consensus. At the same time, responsible, ESG-guided investing is growing dramatically in the US.[6] Given these realities, the fact that a given company is making a serious effort to manage its impact on diverse stakeholders – the core idea of ESG investing – could make that company more attractive to many investors now and in the future and therefore drive up investment value without further inquiry into whether any specific ESG factor would be considered economically material under any particular investment theory. It would be entirely reasonable for an investment professional to consider that potential, among other factors, in making investment decisions. The DOL's proposed regulations

[5] The Harris Poll and Just Capital, "Survey: What Americans Want from Corporate America During the Response, Reopening, and Reset Phases of the Coronavirus Crisis," (May 2020). Available at: https://justcapital.com/reports/survey-what-americans-want-from-corporate-america-during-the-response-reopening-and-reset-phases-of-the-coronavirus-crisis/

[6] *Morningstar 2019 Landscape Report*, 2.

would effectively disable investment professionals from doing so – or at a minimum make it prohibitively cumbersome and legally risky to try.

The DOL's proposed rule would harm plan participants by not allowing ERISA fiduciaries to consider considerations that likely contribute to the strong performance of responsible investments but which are not captured within the framework of the DOL's proposed "economically material" factor analysis. This is arbitrary and capricious.

The Proposed "Economic Materiality" Test Also Fails to Address the Potential Positive Effects of ESG Investing on an Entire Plan Portfolio

ESG factors often address corporate "externalities" – that is, impacts that affect stakeholders other than the company itself and its shareholders. By pushing costs such as pollution or the effects of poverty wages onto third parties, rather than onto its own financial statements, a company may be able to improve its near-term financial performance. ESG investing often favors companies that internalize such externalities. According to the DOL's proposed economic materiality test, if an ESG factor which favors internalizing a cost does not have a demonstrable positive effect on a company's financial performance, it must be disregarded.

However, those externalized costs may be pushed onto other companies or may negatively affect the economy as a whole, which affects all companies. Pension plans are sometimes called "universal owners" because they own a broad cross-section of the investable economy. What is an externality to an individual company, arguably improving its near-term performance, may adversely affect the long-term performance of an entire pension portfolio because of the effects of that externality on other companies in the portfolio and on the economy as a whole, ultimately affecting all companies held in the portfolio.

Internalizing costs at their source allows for the most efficient allocation of those costs within the economy as a whole. For example, companies that must internalize the costs of their carbon outputs can decide to decarbonize their operations or, if more efficient, to purchase offsets in a carbon trading framework. However, if those costs are not internalized, then companies can pursue inefficient, beggar-thy-neighbor practices that damage the economy as a whole – and harm pension plans as universal owners.

By preventing ERISA fiduciaries from considering the potential positive effects of ESG investing on an entire pension portfolio, the DOL's proposed rulemaking potentially subjects plan participants to lower financial returns in contravention of the purposes of ERISA.

If it had been Applied Over the Past Five Years, the "Economically Material" Test Would Not Have Helped Conventional Investors and Would Have Caused Many Responsible Investors to Lose Money

A specific reason why many responsible funds have outperformed their conventional peers over the past five years is that they underweighted investments in the fossil fuel industry. The view that fossil fuels posed outsized financial risks in the relative near-term (five years) was not the "generally

accepted" view five years ago. A responsible investment analyst five years ago would probably not have been able to demonstrate the economic materiality of concerns that he or she had about fossil fuels at that time – at least in terms of "generally accepted investment theories." In any event, he or she almost certainly would not have wanted to have that argument with a DOL investigator in an enforcement context. Yet, the judgment that fossil fuels posed outsized financial risks in the relative near-term turned out to be correct as the industry has lurched from crisis to crisis. Over the past five years, the energy sector component of the S&P 500 index has lost over 35% of its value while the S&P 500 index as a whole (which includes the energy sector) gained over 60%, a staggering level of underperformance for the energy sector.[7] Responsible investments that underweighted the fossil fuel industry made money relative to their conventional peers over the past five years – money that would have been lost to the retirement accounts of responsible retirement investors had the DOL's proposed "economically material" test been applied.

How should investment analysts judge the fossil fuel industry today? Conventional wisdom is that fossil fuels will be part of the world's energy mix for decades to come and that investments in the fossil fuel industry are now fairly priced and should be part of a "diversified" portfolio. But what if that "generally accepted" conventional wisdom is wrong? What if the climate crisis worsens faster than expected, public attitudes shift, governments take serious action to reduce carbon emissions, and fossil fuel companies are suddenly left with hundreds of billions of dollars of stranded petroleum reserves and infrastructure assets that will never be used? That is not the view today of most qualified investment professionals applying "generally accepted investment theories." But they may be wrong going forward, as they were wrong before.

The DOL's proposed rule will likely have the effect of forcing plan participants who strongly disagree with the conventional wisdom on climate change to have their retirement holdings nevertheless tied to the fate of the fossil fuel industry. There is no defensible basis for the DOL to try to second guess portfolio managers who are not persuaded by the conventional wisdom or to impose discriminatory burdens of proof on investors who take ESG considerations seriously.

The DOL's Implicit Rejection of the "All Things Being Equal Test" for ESG Investments Has No Basis in ERISA Giving the Appearance of Political Interference in the Disposition of Investors' Capital

ERISA was adopted to protect retirement savers by setting high standards for retirement plan fiduciaries, requiring them to act with due care, skill, prudence, and diligence and without conflicts of interest. The ultimate goal is to maximize retirement savings for plan participants.

For decades, the "all things being equal test" has been applied to assure that this ultimate goal of ERISA is met. In applying this test, fiduciaries are required to exercise ERISA's high standards of due care, skill, prudence, and diligence without conflicts of interest, and to ensure that investments chosen offer the highest possible expected risk-adjusted returns. However, once this burden has been met and the substantive requirements of ERISA have been satisfied, there is no ERISA-based

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[7] Data from S&P Dow Jones Indices, Energy Select Sector, available at: https://www.spglobal.com/spdji/en/indices/equity/energy-select-sector-index/#overview

justification for the DOL singling out a class of investments – those involving ESG considerations – for deliberately onerous and obstructionist regulatory treatment.

Political interests, coordinated through the US Chamber of Commerce, and heavily supported by the fossil fuel industry, have long been hostile to responsible investment and to the incorporation of ESG factors into investment decision-making. These political interests are backed by corporations that believe that ESG investing could limit their access to capital unless they modify their business practices in ways they oppose. They have a strong voice in the current administration, and it is reported that they played a role in the proposed rulemaking.[8]

These interests have a right to their own political views but have no right to impose their political views on retirement savers who do not share them. Retirement savings represents capital that belongs directly or in trust to plan participants – not to the DOL and certainly not to outside political interests.

Provided ERISA standards are met, retirement investors are entitled to decide, for example, that they do not want their capital to contribute to extreme effects of climate change decades in the future when they are in retirement and answering to their own children for the world they are passing on. Effects decades in the future are beyond the time horizon of any standard investment analysis and so would probably not meet an "economic materiality" test as framed in the proposed rulemaking. However, they would meet a test of meaningfulness to many retirement investors. It's their money.

Once the requirements of ERISA are met – as they are through the "all things being equal" test as traditionally applied – selective interference in the investment preferences of retirement investors to disadvantage ESG investing has all the appearances of the imposition of a third-party political point of view on retirement investors with regard to the disposition of their own capital..

Conclusion: The Proposed Rulemaking Should be Immediately Withdrawn

ESG investing is gaining rapidly in popularity and acceptance among investors. In 2019, capital contributions to the 303 ESG-focused funds tracked by Morningstar exceeded the previous record set in 2018 by nearly fourfold.[9] That trend continued in 2020.[10] A survey of active investors by Morgan Stanley indicated that 90% of those in the millennial generation wanted ESG options in their 401(k) plans.[11] Millennials are already the largest cohort in the US workforce.[12]

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[8] MacKenzie, Kate, "Trump's Plan to Block Pensions from ESG Won't Help Fossil Fuels" (July 8, 2020) Bloomberg Green. Available at: https://www.bloomberg.com/news/articles/2020-07-08/trump-s-plan-to-block-pensions-from-esg-won-t-help-fossil-fuels.

[9] *Morningstar 2019 Landscape Report*, 2

[10] Hale, Jon, "Despite the Downturn, US Sustainable Funds Notch a Record Quarter for Flows" (April 9, 2020) Morningstar, 1. Available at: https://www.morningstar.com/articles/977328/despite-the-downturn-us-sustainable-funds-notch-a-record-quarter-for-flows

[11] Morgan Stanley, Institute for Sustainable Investment, *Sustainable Signals: New Data from the Individual Investors* (2017) ("*Sustainable Signals*"), 2. Available at: https://www.morganstanley.com/pub/content/dam/msdotcom/ideas/sustainable-signals/pdf/Sustainable_Signals_Whitepaper.pdf

[12] Fry, Richard, "Millennials are the Largest Generation in the U.S. Labor Force" (April 11, 2018), Pew Research Center, 1. Available at: https://www.pewresearch.org/fact-tank/2018/04/11/millennials-largest-generation-us-labor-force/

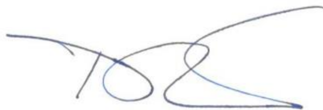
Major asset managers are joining the movement to ESG investing including the largest, BlackRock. In his 2020 letter to CEOs, BlackRock's Chairman and CEO, Larry Fink, stated bluntly: "We believe that sustainable investing is the strongest foundation for client portfolios going forward."[13] US SIF, the leading responsible investment association, documented in 2018 $12 trillion in US investment assets that apply some form ESG consideration – fully one quarter of professionally managed US investment assets.[14]

While the popularity of an investment approach is not a reason for its inclusion in ERISA plans, the broad and growing acceptance of ESG investing by both investors and the investment industry should be a reason for humility for regulators. As argued in these comments, the proposed DOL rulemaking fails to reflect the investment process as actually practiced and offers no persuasive legal justification for why decades of precedent and practice should be tossed aside. There can be little doubt that responsible, ESG-guided investment will continue to grow rapidly as part of the overall investment world. If the proposed rulemaking goes into effect, that growth in the US will take place almost entirely outside of ERISA-regulated retirement plans, denying plan participants the opportunity to benefit from the potentially superior financial performance of ESG-guided investing as well as the opportunity to have the deployment of their own capital better reflect their values.

For these reasons, the Proposal should be immediately withdrawn from further consideration.

Thank you for your consideration.

Sincerely,



David B. Keto
Managing Principal

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[13] Fink, Larry, "A Fundamental Reshaping of Finance" (2020 Letter to CEOs). Available at: https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter

[14] US SIF, *Report on US Sustainable, Responsible and Impact Investing Trends 2018* (2018) ("*US SIF Trends Report*"), 9. Available from US SIF, www.ussif.org.