The Investment Association (IA) evidence for the Employee Benefits Security Administration, U.S. Department of Labor (DOL), concerning Proposed Rule (RIN 1210-AB95): Financial Factors in Selecting Plan Investments.

Executive Summary

- **UK-based managers from IA members invest $670bn in U.S. equities, providing support for businesses in every state. UK investment managers, supported by an effective and proportionate regulatory framework, play a significant role through the delivery of responsible investment and our experience is that this role is entirely consistent with the objective to generate sustainable value for savers over their investment time horizons.**

- **The DOL proposals as set out here try to treat environmental, social, and governance (ESG) exclusively as a specific asset class rather than as an integral part of the investment process, which the broad term of ESG represents for funds in the day-to-day business of investment. The concern expressed to the IA is that many of the issues the DOL would like to separate out as ESG are in fact a key part of the investment management process, and correspond to financial factors, the exclusion of which would have material consequences on the generation of returns for investors.**

- **The IA would welcome the opportunity to brief and discuss its industry-led *Responsible Investment Framework and supplementary definitions* with the DOL and others interested in our work.**

About the IA and the industry

1. The Investment Association (IA) represents the UK investment management industry, supporting global savers, investors and businesses.

2. Our 250+ members invest more than $670bn in U.S. equities, providing support for businesses in every state, and returns for international savers and investors.

Defining the issue

3. The policy problem that the proposed changes are supposed to solve is set out in the proposed guidance in Section 1.1 of the regulatory impact analysis: *"The Department is concerned that the growing emphasis on ESG investing, and other non-pecuniary factors, may be prompting ERISA plan fiduciaries to make investment decisions for purposes distinct from their responsibility to provide benefits to participants and beneficiaries and defraying reasonable plan administration expense".*

4. By seeing ESG exclusively in terms of a distinct asset class for funds and never as a broad approach for securing long term value, the DOL has mischaracterised it, and its use. Specifically, it has grouped all forms of ESG investment together – conflating ESG as a tool for risk management and the generation of long term returns with dedicated ESG strategies

which may seek additional ESG outcomes and which require investors to make an active choice to invest in such a way. The generic term itself may seem modern but the principles that underpin it are as old as the industry itself: ESG integration can in some instances be about non-pecuniary outcomes but it can just as readily be about managing risk and opportunity from a pecuniary perspective, and as such is relevant across all asset classes.

5. For the investment management industry a key challenge is the wide range of terminology used with regard to ESG issues, including how the environmental characteristics of investment products are disclosed. Having such a generic term is also a challenge for regulators. The DOL's supplementary information notes this well when it says, *"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.*[14]"

6. The supplementary information provided by the DOL explains *"[a] fiduciary's evaluation of the economics of an investment should be focused on financial factors that have a material effect on the return and risk of an investment based on appropriate investment horizons consistent with the plan's articulated funding and investment objectives."* [11] The concern expressed to the IA is that many of the factors the DOL may separate out as ESG are in fact integral to the investment management process, and would indeed have a material effect on the return and risk of an investment.

7. The DOL's treatment of ESG effectively groups all forms of ESG investing together in a way that confuses the management of material risk factors with the pursuit of ESG outcomes. The fundamental aim of the DOL proposal is to ensure investors' fiduciary interests are not subordinated to politically motivated, non-pecuniary ambitions. There are some strategies that offer the opportunity for investors to invest with a view to generating specific positive impacts which may provide below-market rate returns. However, only a certain kind of investor – effectively a donor – who specifically knows that this is the case and can accept the risk to capital, could operate in that kind of space. This is not the case for the vast majority of funds and their investors.

ESG in action

8. UK investment managers, supported by an effective and proportionate regulatory framework, play a significant role through the delivery of responsible investment. Our experience is that this role is entirely consistent with the objective to generate sustainable value for savers over their investment time horizons.

9. Investment managers' role as stewards of their clients' assets involves oversight, management and engagement on financially material issues that will impact on the sustainable value of an asset. Investment managers will engage on a wide range of pecuniary issues such as strategy and financial performance, audit and accounting, capital management and remuneration as well as ESG issues such as human capital and board diversity. This is not a definitive list - investors will focus on relevant and material issues for the asset under consideration.

10. Through this role, investment managers can play a significant part in supporting and challenging companies on issues that are material, to generate sustainable value for savers on issues that are financially material for the company in question. Stewardship of investee companies can involve:

- Setting clear expectations of companies;
- Engaging with investee companies and holding them to account;
- Exercising rights and responsibilities (including voting at company annual general meetings (AGMs);
- Escalating concerns for example through collective engagement or public statements; and
- Finally, exiting the investment, if possible, and if continuing to hold the asset is no longer in the best interests of savers.

11. Active and index strategies use stewardship at different points in the investment process. For example, while index strategies do not use stewardship to inform buy and sell decisions, as long-term holders of companies in a constructed index, they use oversight, engagement and the exercise of voting rights, where relevant, to ensure the long-term quality and performance of the assets held.

Conclusion – Responsible Investment

12. For the investment management industry a key challenge is the wide range of terminology used with regard to ESG issues, including how the environmental characteristics of investment products are disclosed. Having such a generic term is also a challenge for regulators. The DOL's supplementary information notes this well when it says: *"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.*[14]"

13. The aim, one shared by the DOL, is to provide greater clarity and consistency to the way the industry describes these products to clients, and to make it easier for all savers to understand the opportunities available to them. In the UK, the IA moved away from using ESG as its leading preferred term – preferring responsible investment - and launched the first ever industry-agreed *Responsible Investment Framework and supplementary definitions.*

14. **The IA would welcome the opportunity to brief and discuss the *Responsible Investment Framework and supplementary definitions* with the DOL and others interested in our work.**

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