July 27, 2020

Preston Rutledge
Assistant Secretary of Labor for Employee Benefits
U.S. Department of Labor
200 Constitution Ave NW
Washington, D.C. 20210

Re: ESG and Fiduciary Duty: Comments on rule proposal regarding Financial Factors in Selecting Plan Investments; RIN 1210-AB95[1]

Dear Mr. Rutledge,

We are grateful for the opportunity to comment – on our own behalf and representing our own views – on the DOL's proposed rule regarding financial factors in selecting plan investments.

We commend the intention to provide clarity around a complicated subject (especially with respect to *Fifth Third Bancorp vs. Dudenhoeffer 573 U.S. 409 (2014)*, *ERISA,* and previous DOL guidance) and to protect the interest of retirement plan beneficiaries.

We find the rule in its current form may go some distance in achieving these objectives. However we find that some features of the proposed rule would damage rather than improve retirement plan investment outcomes, and would unduly limit alternatives available to 401(k) participants.

"Generally accepted investment theory"

Imposing the condition that financial materiality of ESG factors must be recognized by "generally accepted investment theory" creates a multifaceted deleterious effect on retirement plan investment outcomes:

1. It excludes investment strategies with more sophisticated research or methodology with respect to the financial materiality of ESG factors than what is offered by "generally accepted investment theory", damaging investment outcomes.
2. It stunts the research and development surrounding the financial materiality of ESG factors, which is an increasing and increasingly important domain of research with respect to long-term investment outcomes.
3. It opens the door for special-interest control of what constitutes "generally accepted investment theory", rather than allowing this to be achieved by an informed marketplace.
4. The example objective criteria named in Paragraph (c) (3) such as benchmarks, expense ratios, long-term returns, etc. are insufficient for evaluating prospective

[1] https://www.federalregister.gov/documents/2020/06/30/2020-13705/financial-factors-in-selecting-plan-investments

investment performance. Therefore limiting consideration to these would damage investment outcomes. In addition to these example criteria, the prudent fiduciary also examines investment philosophy and process, which in many cases can include ESG data integration. The proposed condition effectively precludes the consideration of many relevant aspects of an investment strategy, of which ESG factors represent only a small subset.

5. The condition is especially limiting for large and diversified institutional investors or investment managers, for whom what is a non-pecuniary (financially immaterial) consideration with respect to a single investment can become a pecuniary (financially material) consideration for the total portfolio. This 'internalization' of business activity externalities arises when costs are systemically transmitted via social, environmental, or purely market mechanisms, including through impacts on human capital, climate and environmental risk, and systemic financial risk. It is not the place of the DOL to constrain fiduciaries from generating and applying the research and investment methodologies which take account of these transmission mechanisms in pursuit of better investment outcomes.
6. It perpetuates the conflation of ESG data integration and non-pecuniary objectives.

Participant-directed retirement plans

Excluding non-pecuniary objectives from all QDIAs in participant-directed retirement plans is arguably consistent with the interpretation of fiduciary duties under *ERISA* according to *Fifth Third Bancorp vs. Dudenhoeffer 573 U.S. 409 (2014).* However, the proposal to exclude investment strategies from QDIA status on the basis either of ESG data integration or a strategy name which includes "ESG" or "Sustainable" is a result of – and perpetuates – the conflation of ESG data integration and non-pecuniary objectives. Many investment strategies which integrate ESG data, or which carry the name "ESG", have no non-pecuniary objectives.

More generally, plan beneficiaries have increasingly sought to direct their fiduciaries to select "social" and "green" investments, even in cases where these are likely to lead to relatively lower financial returns. As this trend intensifies, the reduction of "the interest of the beneficiary" to "pecuniary interest" becomes increasingly inaccurate. Although the proposed rule references "long-established fiduciary standards", this reduction of "interest" to "pecuniary interest" was codified only in 2014 and is moreover inconsistent with legal developments in Europe and the UK, where fiduciaries have recognized scope to consider the non-pecuniary concerns of their beneficiaries. There is a clear need to modify legal and regulatory frameworks in order to create the flexibility necessary to preserve participants' rights to define their interests. The proposed rules move in the opposite direction. We would go so far as to suggest the President postpone rulemaking until *ERISA* is reformed to reflect a broader interest of the beneficiary beyond pecuniary interest.

This increased flexibility is needed in a broad range of fiduciary relationships with respect to retirement assets, but especially and immediately needed for participant-directed retirement plans. Especially but not solely outside QDIAs, there should be a wide scope for participants to

make informed decisions which weigh pecuniary and non-pecuniary objectives in a manner consistent with *ERISA's* interpretation under the case mentioned above.

An important component of an informed marketplace is the role of names and disclosures with respect to investment strategies and investment objectives, including any non-pecuniary objectives. To this effect, we have also responded to the SEC's request for comment on proposed modifications to the Names Rule with respect to "ESG" and "Sustainable". Our response, which emphasizes the importance of distinguishing and disclosing non-pecuniary objectives precisely with respect to fiduciary duties, can be found here.[2]. Under that framework we proposed an "ends test" to distinguish collateral benefits (non-pecuniary) objectives from risk-return objectives, followed by a "means test" with technical standards for each discrete set of objectives, including 1) pecuniary objectives only; 2) pecuniary and non-pecuniary objectives; 3) pecuniary objectives only with non-pecuniary disclosures.

In sum, although we believe the DOL's proposed rule goes some way in clarifying the subject and protecting beneficiary interests, it also

1. Damages their interest by limiting investment outcomes
2. Constrains beneficiaries' investment options, most unreasonably for those in participant-directed retirement plans
3. Emphasizes the "means test" of ESG data integration while sidestepping the more important "ends test" of disclosure around non-pecuniary objectives
4. Stunts research and development regarding the financial materiality of ESG factors
5. Perpetuates the conflation of ESG data integration and non-pecuniary objectives.

We value the effort of the DOL to protect American workers' retirement and are grateful for the opportunity to comment.

Sincerely,

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The views expressed herein are the authors' own.

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[2] https://www.sec.gov/comments/s7-04-20/s70420-7153876-216457.pdf