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July 30, 2020

Office of Regulations and Interpretations
Employee Benefits Security Administration
U.S. Department of Labor
Room N-5655
U.S. Department of Labor
200 Constitution Avenue NW
Washington, DC 20210
Via Federal eRulemaking Portal at www.regulations.gov

Re: Financial Factors in Selecting Plan Investments
Proposed Regulation (RIN 1210-AB95)

Dear Department of Labor:

Our firm is a North Carolina based wealth manager which primarily serves individuals and small to mid-sized institutions, including retirement plans. The following comments on the proposed rule arise from a practitioner's perspective. For the last several years the author of this comment letter has also served on the Plan Sponsor Council of America's Investment Committee leading their efforts to stay abreast of ESG developments and issues, and has been privileged to author several articles providing observations and thought leadership to their membership.

As a fiduciary, we understand the obligations of prudence and loyalty in serving the sole interests of our clients, and thus share the same interests as the Department in safeguarding the interests of retirement plan participants and beneficiaries. The importance of clear communication and well-written investment guidelines is critical towards protecting the interests of all parties.

Despite the aim of providing clarity for ERISA fiduciaries, the proposal instead introduces more confusion. Our comments will hopefully further inform staff and policymakers and provide suggestions for improvement.

The most prominent deficit in the proposal is the mischaracterization of environmental, social, or governance factors (ESG) factors as promoting or offering ***only*** "collateral" or "non-pecuniary" (non-financial) benefits. As explained below, modern developments in investing theory and practice have clearly identified the use of ESG factors as a critical and appropriate input into a fiduciary due diligence process. If the Department wishes to retain this "non-pecuniary" characterization for all ESG investments, then we suggest that guidance in the Rule concerning ERISA fiduciary duties should be re-drafted to neither promote nor preclude the consideration of plan investments because of non-financial objectives (i.e. ESG factors), thereby returning the focus squarely to the consideration only of investment return and risk -- for all types of investments.

Alternatively, the Department could choose to qualify specific methods of economic consideration, such as "**ESG Integration**", as an appropriate fiduciary task, thus separating it from other ESG approaches which pursue narrower mandates (carbon reduction, workplace diversity etc.) This could help to ameliorate concerns about lack of ESG uniformity cited in the proposal.

Modern Methods of Financial Analysis

DOL references 30 years of periodic updates to guidance around what was originally described as economically targeted investments (ETIs), acknowledging a need to recognize and respond to changes in investment theory and practice. Nowhere in the subsequent guidance, however, is there a discussion of how what has come to be known as ESG investing is different from ETIs. **ESG integration** specifically, as suggested above, is an analytical process that rigorously considers ESG factors as part of prudent risk management leading to investment actions aimed at responding to those risks. By contrast, ETIs are investments that aim to provide financial returns as well as collateral, non-financial benefits. For example, ETIs (as well as some types of ESG investing) often pursue job creation/community benefits or the reduction of carbon emissions as goals of the investment (sometimes called impact investing and green investing). <u>This failure to distinguish between the two can and should be addressed with updated language in the proposal</u>.

ESG integration, specifically, is a process by which an asset owner, investor, or other organization utilizes a rules based (and sometimes proprietary) methodology to rank order, grade or rate certain companies to arrive at a lower risk profile versus equivalent investments (i.e. Pepsi might have less exposure to material risk factors than Coca-Cola). It most particularly is not an "investment behavior" as DOL asserts for all ESG investments. This holistic analytical approach is in perfect harmony then with ERISA Section 404 which requires plan fiduciaries to act prudently and diversify plan investments so as to minimize the risk of large losses.

Recent examples of companies with poor ESG integration profiles include British Petroleum (Deepwater Horizon incident in 2010), Volkswagon (emission scandal 2015), and Equifax (data breach 2017). In all of these and similar cases, the company's stock price declined precipitously versus broad market indices, producing significant performance drag and harming America's retirement savers who owned funds with exposure to these companies. Funds using ESG integration largely avoided these significant losses - clearly a worthy financial objective and paramount fiduciary duty under ERISA.

As a critical validation of this understanding, the world's largest professional organization dedicated to training and credentialing security analysts and portfolio managers worldwide, the CFA Institute, formally defined and adopted the use of **ESG factors** as part of their standard analytical framework investment in 2015, concluding that *"…systematically considering ESG issues will likely lead to a more complete investment analysis and better-informed investment decisions."* This framework has been incorporated into their Body of Knowledge and is now an important part of the curriculum and testing program for all the world's aspiring investment analysts. In effect, the rule's requirement that "*ESG or other similarly oriented investments are pecuniary factors only if they present economic risks or opportunities that qualified investment professionals would treat as material economic considerations under generally accepted investment theories*" [2550-404a-1 (c)(1)] has already been validated by that body whose membership comprises the most highly qualified group of investment professionals worldwide.

Further, the ability of plan fiduciaries to utilize ESG integration consistently upholds the directives of updated guidance over the years. IB 94-1's "tie breaker" or "all things being equal" standard is obviated since a complete investment opportunity set is included at the outset of any analysis (the S&P 500 for instance is reduced to the S&P ESG 500 -- i.e. there are no "alternative" investments to consider offering "collateral benefits" since all investment alternatives are treated the same). IB 2008-01 and IB 2015-01 both emphasize the primary focus for plan fiduciaries must be the plan's financial returns and risks to participants and beneficiaries: ESG integration has at its core the reduction of material risks (i.e. there are no other "unrelated objectives").

The Issue of Materiality and the Rise of Intangibles

FAB 2018-01 is considered by many to be confusing and contradictory, as it states that "*fiduciaries must not too readily treat ESG factors as economically relevant*" when making investment decisions. FAB 2018-01 does correctly state that "*a fiduciary's evaluation of the economics of an investment should be focused on financial factors that have a MATERIAL EFFECT (our emphasis) on the return and risk of an investment*".

The issue of materiality goes to the heart of all investment analysis, <u>and DOL should carefully consider the ongoing and rapid evolution of financial reporting standards</u> which recognize how important ESG factors are becoming to a proper and more complete evaluation of a company's health via its financial statements.

Inherent in the CFA Institute's decision to adopt ESG factors as a prudent and proper addition to rigorous security analysis was the understanding that <u>the analysis and management of material risks is a key driver in the creation of long-term economic value (i.e., return on investment</u>). Data and evidence demonstrate that ESG integration provides important insights regarding material issues that can harm a company's performance (i.e. negatively impact returns). Global financial reporting is rapidly transitioning to conform and implement standards that more accurately reflect these material risks, led by diverse organizations like the Global Reporting Initiative, the International Integrated Reporting Council, and the Sustainability Accounting Standards Board (see https://materiality.sasb.org/ for SASB Materiality Map® for instance). Users of financial statements recognize that value creation and destruction is inextricably linked to a company's intangible assets, which are now significantly greater than physical assets (predominant in bygone eras).

<u>The rule should recognize this fundamental shift in asset valuation</u> as it directly impacts investment outcomes (i.e. evaluation of "material risk" and "economic considerations" should not exclude ESG factors). FAB 2018-1 states that "*the weight given to those factors (ESG applied to alternative investments) should also be appropriate to the relative level of risk and return compared to other relevant economic factors.*" The ascendancy of intangibles demonstrates that the use of ESG factors is highly appropriate and should feature prominently in any economic consideration of any investment under consideration by a plan fiduciary.

Selection of Designated Investment Alternatives (DIA) and Qualified Default Investment Alternatives (QDIA)

We are concerned that the additional new record-keeping requirements imposed by the proposal ("heightened standards") will discourage the consideration and use of any type of ESG investment as a DIA, thus preventing ERISA fiduciaries from accessing funds and strategies that have a successful record of reducing risk and preserving (or enhancing) return potential. Further, this forced limitation of the investment opportunity set interferes with the pursuit of "prudent diversification" and is not a reasonable input into the development and operation of proper investment review processes for ERISA fiduciaries. Finally, given the demonstrated preference for ESG investments (especially by younger plan participants)[1], the proposal may provide a disincentive for saving via the absence of ESG funds as DIAs or QDIAs in retirement plans, causing significant harm to the retirement readiness of millions of Americans.

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[1] Morgan Stanley Institute for Sustainable Investing, "Sustainable Signals", 2019: 88% of survey respondents would be "somewhat interested" or "very interested" in investing in an ESG fund if it was added to a plan.

Many rigorous studies have demonstrated that investment returns are not sacrificed when using ESG factors and actually may be enhanced[2]. In the recent pandemic related US stock market sell-off, for instance, Morningstar found that the vast majority (24 of 26) sustainable index funds outperformed the comparable conventional index fund.[3] A notable reduction in risk has also been demonstrated by others[4]. Growing evidence demonstrates the efficacy of ESG factors in reducing risk and preserving (or enhancing) return, and the language as proposed will serve to highlight ERISA's deficiency in not acknowledging the usefulness of ESG integration as an appropriate additional input in the overall fiduciary due diligence process.

In a recent Barron's opinion piece "Breaking Down Walls to Private Equity" (July 27, 2020), the Department's Deputy Secretary Patrick Pizzella listed many reasons which supported DOL's recent information letter approving the inclusion of professionally managed funds that have some **private equity** exposure for 401(k) plans. He noted particularly that "*there is no reason that a 401(k) fiduciary, charged with a strong duty of care and a mandate to act solely in plan participants' interests, should be foreclosed from providing participants with the full range of market options—including private equity—when it's prudent to do so*." Yet this "foreclosure" (of ESG funds) is precisely the outcome that will result from the implementation of the proposal without any changes.

It follows from the above discussion that <u>any DIA, properly selected and vetted from a complete opportunity set, should not be precluded from being offered as a QDIA</u>. In particular, the ability of a participant to direct their investments should not be limited solely by a determination that non-financial objectives are present, especially when such investments demonstrate a superior risk-reward profile using an objective and consistently applied fiduciary review process. <u>We encourage the Department to harmonize the DAI and QDIA requirements to reflect that additional factors as demonstrated by ESG integration are reasonable inputs into the economic considerations required for vetting DIAs and QDIAs</u>.

Marketplace Functions and Fees

Department commentary also describes how the growing use of investments using the term "ESG" term has been accompanied by "*a lack of precision and rigor in the ESG investment marketplace*", further noting that "*there is no consensus about what constitutes a genuine ESG investment*" and how the marketing of various ratings systems may be contributing to this growth. DOL also notes that "*ESG funds often come with higher fees*".

We would observe that these comments are not germane solely to ESG investments. Even in "traditional" investments, there can exist a lack of rigor and precision (perhaps explaining why more than a quarter of publicly traded mutual funds close or shut down after less than 10 years in business). Many would be hard pressed to describe a genuine "growth" or "value" fund, especially as investing regimes rotate from one style to another and fund managers "tilt" accordingly. Higher fees are similarly not the exclusive province of ESG funds; actively managed "traditional" mutual funds for decades have charged many times more than funds dedicated to passive approaches, mostly with sub-par results (harming retirement plan savers). In sum, the marketplace will sort these issues out and, especially with respect to the marketing of ESG funds (as with the marketing of all funds), perceived or real infractions may best be addressed by other agencies like the SEC, which already has in place rules in place to address deceptive marketing practices.

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[2] University of Hamburg "ESG and Corporate Financial Performance" (December 2015), Savita Subramanian, ESG Part II, A Deeper Dive, Equity Strategy Focus Point, June 2017

[3] "Sustainable Funds Weather the First Quarter Better Than Conventional Funds", Jon Hale, Morningstar publication, April 2, 2020

[4] Morgan Stanley Institute for Sustainable Investing, "Sustainable Realty: Analyzing Risk and Returns of Sustainable Funds", 2019

Investment Best Practices and Global Regulations

ESG integration is now considered by an overwhelming majority of the world's investors to be a proper application of fiduciary due diligence (including over 3,000 of the world's largest investors who are signatories to the United Nations Principles for Responsible Investing). These stewards oversee the vast majority of retirement savings pools word-wide, and certainly meet the test of "prudent expert" or "qualified investment professional".

Global regulators have likewise modernized rules and regulations to require plan fiduciaries to consider ESG factors (in addition to already established and accepted traditional analytical methods) as part and parcel of good stewardship and prudent practices for plan fiduciaries. Many jurisdictions in Europe (France and the UK in particular) have even mandated that retirement plan sponsors must use ESG factors in their analysis or explain why they are not being utilized. DOL's proposed rule runs counter to global regulatory movement and does not reflect credit on the Department's understanding of the full spectrum of modern investment risks (especially on display now as a result of the COVID-19 pandemic).

We appreciate the Department's ongoing and well-intentioned efforts to promote and effectuate the safety and security of America's retirement plans. We hope these comments have been helpful. We are committed to upholding the highest standards of fiduciary care while embracing the continuing evolution of best investment practices, and we look forward to any further developments regarding the proposed rule.

Sincerely,

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