Thursday, July 30, 2020

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

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

Dear Director Canary:

On behalf of *Etho Capital LLC*, an investment management firm, we thank you for the opportunity to submit comments on the notice of proposed rulemaking entitled *Financial Factors in Selecting Plan Investments*. In our view, the Department of Labor fails to articulate a rational connection between the relevant facts and the Proposed Rule.

First, the proposed rule reveals a fundamental misunderstanding of how professional investment managers use environmental, social, and governance (ESG) criteria as an additional level of due diligence and analysis in the portfolio construction process. Investment managers increasingly analyze ESG factors precisely because they view these factors as material to financial performance and the evidence of this connection is demonstrated by consistent out-performance of ESG products relative to conventional investment products.

Additionally, the Proposed Rule inappropriately creates new burdens for fiduciaries under the *"all else being equal test"* that will lead to unnecessary costs for plan participants and creates confusion about what activities the DOL is attempting to regulate.

In light of these issues, we are very concerned about the proposed rule and wish to see it withdrawn.

ESG Integration

Integrating environmental, social, and governance (ESG) factors into investment activities are essential to fulfilling fiduciary obligations to engage in appropriate risk management. We believe that the proposed rule fundamentally misconstrues the importance and role of ESG integration in reducing risk and increasing returns. Further, the proposed rule is likely to lead to increased confusion and costs for retirement plan fiduciaries. We, therefore, urge you to retain existing guidance and not move forward with a final rule.

Despite the Proposed Rule's stated goal of providing clarity for ERISA fiduciaries, it creates confusion due in part to a failure to distinguish ESG integration and Economically Targeted Investing (ETI). ESG integration is the consideration of risk factors as part of prudent fiduciary management and a strategy that takes these factors into account in investment actions. ETIs are investments that aim to provide financial returns as well as collateral, non-financial benefits. For example, ETIs often advertise job creation or climate impact as the goals of the investment.[1]The Proposed Rule states that ERISA fiduciaries have fulfilled their obligations if they have *"selected investments and/or investment courses of action based solely on pecuniary factors"* and that *"ESG factors and other similar factors may be economic considerations."* In fact, there is now an extensive body of research that

[1] For further discussion of ESG integration as an investment strategy, see Gary, S. *Best Interests in the Long-Term: Fiduciary Duties and ESG Integration*, 90 U. Colo. L. Rev. 733, 745 (2019), attached hereto as **Exhibit A** and incorporated into this comment letter in full.

makes clear that ESG factors are material investment considerations.[2] As such, there exists a sound basis for integrating ESG factors into investment actions.

A policy by the DOL that simply clarifies that fiduciaries must integrate material factors into their investment actions and that ESG factors may be material, would be appropriate. We are concerned, however, that the remaining components of the proposal create confusion and are likely to cause fiduciaries to believe they are not permitted to consider material ESG factors in their investment analysis.

The "all else being equal test"

We are also very concerned that the Proposed Rule inappropriately creates new burdens for fiduciaries under the *"all else being equal test"* that will lead to unnecessary costs for plan participants. It also creates confusion about what activities the DOL is attempting to regulate.

Currently, under the *"all else being equal test,"* which has been in place since 1994, fiduciaries may select an investment that provides collateral benefits only after they have determined that the risk and return profile of that investment option is substantially similar to that of competing options that would meet the financial needs of the fund. The Proposed Rule proposes the retention of the *"all things being equal"* test but adds new and costly record-keeping requirements for fiduciaries to document their conclusion that multiple options are equal and that it is, therefore appropriate to make a decision based on collateral benefits.

Below is a chart detailing three examples of traditional ETFs and their ESG counterparts. As shown, funds that integrate ESG factors into their plans perform on par or better than their conventional counterparts. This indicates that ESG factors can indeed be material rather than non-pecuniary factors.

Conventional ETFs vs. ESG Integrated ETFs

	SPDR® S&P 500 Fossil Fuel Rsrv Free ETF	SPDR® S&P 500 ETF Trust	SPDR® MSCI EM Mkts Fossil Fuel Free ETF	iShares MSCI Emerging Markets ETF	iShares MSCI ACWI Low Carbon Target ETF	iShares MSCI ACWI ETF
Has Sustainability Mandate?	**Yes**	**No**	**Yes**	**No**	**Yes**	**No**
Shareclass ticker	SPYX	SPY	EEMX	EEM	CRBN	ACWI
1 year (Annualized)	8.59%	7.31%	-2.01%	-4.24%	2.99%	2.05%
2 year (Annualized)	10.07%	8.65%	-0.43%	-1.05%	4.86%	4.17%
3 year (Annualized)	11.06%	10.56%	1.19%	1.22%	6.21%	6.23%
4 year (Annualized)	13.36%	12.63%	n/a	3.97%	8.83%	8.91%
Y-T-D (Annualized)	-4.51%	-6.27%	n/a	-19.68%	-11.33%	-12.04%

* All values as of 6/30/2020

Source: Bloomberg

[2] See, e.g., Amato, J.V., and Dyott, I.S., ESG Investing: An Active Approach to Long-Term Value Creation, Neuberger Berman (2019), www.nb.com/documents/public/global/t0349_0119_wp_esg_investing_an_active_approach.pdf, attached hereto as **Exhibit B** and incorporated into this comment letter in full; Ballentine, C., ESG Stock Resilience Is Paving the Way for a Surge in Popularity, Bloomberg (31 Mar. 2020), www.bloomberg.com/news/articles/2020-03-31/esg-stock-resilance-is-paving-the-way-for-a-surge-in-popularity, attached hereto as **Exhibit C** and incorporated into this comment letter in full; Hale, J. Sustainable Funds Weather the First Quarter Better Than Conventional Funds, Morningstar (3 Apr. 2020), www.morningstar.com/articles/976361/sustainable-funds-weather-the-first-quarter-better-than-conventional-funds, attached hereto as **Exhibit D** and incorporated into this comment letter in full; Konqui, M.H, et al. Why Using ESG Helps You Build Better Portfolios, Lyxor Asset Management (July 2019), www.lyxor.com/why-using-esg-helps-you-build-better, attached hereto as **Exhibit E** and incorporated into this comment letter in full; Logan, L., Commentary: Active Beats Passive in Promoting Sustainable Development, Pension & Investments (23 Apr. 2020), www.pionline.com/industry-voices/commentary-active-beats-passive-promoting-sustainable-development, attached hereto as Exhibit E and incorporated into this comment letter in full; Wurtz, F., ETFs for ESG: Why Passive Makes Sense for ESG, IPE (2019), www.ipe.com/etfs-for-esg-why-passive-makes-sense-for-esg/10033627.article, attached hereto as **Exhibit F** and incorporated into this comment letter in full. See also Gary, S., supra, 90 U. Colo. L. Rev. 733 (2019).

The Proposal's discussion of the *"all things being equal test"* is cause for confusion because, while the test was originally developed to guide the consideration of ETIs, and the discussion in the Proposal appears to envision the selection of an ETI investment, the language of the Proposal does not distinguish the application of this test from the broader discussion of ESG integration, inappropriately suggesting that the documentation requirement is necessary whenever ESG factors are considered.

Defined contribution plan investment options

The Proposed Rule states that ERISA fiduciaries may select *"ESG-themed funds"* as an investment option for a participant-directed plan but that an *"ESG-themed fund"* cannot be selected as the default investment option. This determination appears to be based on confusion between ESG integration and ETIs. In our view, all investment options should be required to integrate ESG factors as part of prudent investment decision-making. In addition, it may be appropriate for ERISA fiduciaries to offer ETIs as options that participants may select in participant-directed plans.

ESG issues can have a material impact on the financial performance of securities as well as the sustainability of the markets for future investors. In 2015 the Supreme Court confirmed that "a trustee has a continuing duty—separate and apart from the duty to exercise prudence in selecting investments at the outset—to monitor, and remove imprudent trust investments."[3]Fund investors can create market volatility and undermine sustainable wealth creation when they fail to account for material ESG factors, undermining the interests of future beneficiaries.

The Department's stated rationale for prohibiting an "ESG-themed fund" from being selected as the default investment option is that it is not appropriate to select "investment funds whose objectives include non-pecuniary goals." This statement shows a fundamental misunderstanding of the purpose of ESG integration, which is to integrate all material factors into investment decision-making. In addition, it is likely to confuse fiduciaries as they attempt to rationalize the Department's statements in the Proposed Rule that ESG factors are likely to have a material economic impact with the discussion of ESG factors in this context, in which the Department has deemed them "non-pecuniary."

Conclusion

The Proposal mischaracterizes ESG integration and fails to distinguish between ESG integration and economically targeted investing. This is likely to lead to confusion for ERISA fiduciaries and costs to plan savers. If the Proposal is finalized in its current form, we are concerned that fiduciaries will struggle to fulfill their obligations to integrate all financially material risk factors while also trying to respond to the language in the Proposal that appears to be aimed at preventing fiduciaries from taking account of these same risks.

Institutional investors have a duty to act in the best, long-term interests of their beneficiaries.

The Proposal as written is anathema to this aim and is likely to have the perverse effect of dissuading fiduciaries, even against their better judgment, from offering options for their plans that consider ESG factors as part of the evaluation of material financial criteria. As a result, it will unfairly, and harmfully, limit plan diversification, and perhaps compel plan participants to choose options that are either riskier or less profitable.

At Etho Capital, we understand (and continue to demonstrate empirically) that ESG factors are financially material. Integrating ESG factors are core to prudent investment decision-making.

If the Proposed Rule goes into effect, it will undermine fiduciaries' ability to act in the long-term best interest of their beneficiaries. As such, we urge you to allow the existing guidance to remain in effect and not move forward with a final rule.

[3] *Tibble v. Edison International*, 135 S. Ct. 1823, 1828-29 (2015)

Thank you for your time and consideration.

Best regards,

Amberjae Freeman
Chief Executive Officer
Etho Capital, LLC