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 Regulation (RIN 1210-AB95)

Dear Director Canary:

The Center for International Environmental Law (CIEL), submits the following comments on the notice of proposed rulemaking entitled "Financial Factors in Selecting Plan Investments" ("Proposal" or "Proposed Rule"). The Proposed Rule seeks to address a non-existent problem, and in doing so erects barriers to the prudent exercise of fiduciary duty under the U.S. Employee Retirement Income Security Act of 1974, as amended (ERISA). In imposing indirect and direct obstacles to environmental, social and governance (ESG) investments by ERISA plan managers, the Proposed Rule departs from an unsubstantiated premise: a presumption that ESG investments generate lower returns than "traditional" or non-ESG alternatives and therefore that the documented increase in ESG investment in recent years threatens the interests of retirement plan beneficiaries. To the contrary, there is ample evidence that integrating ESG factors, such as climate impacts, into investment strategies can increase returns and reduce risk. For defined-benefit plans, the Proposed Rule introduces confusing, unnecessary and potentially burdensome requirements likely to chill decisions to invest in ESG vehicles that would protect fund assets. For defined-contribution plans, the Proposed Rule would explicitly prohibit fiduciaries from acting in accordance with their fiduciary obligations and the best available investment advice, by prohibiting the designation of an ESG fund as a default investment option in an ERISA plan *even* if it is selected on the basis of purely pecuniary, risk-return criteria. As such, we respectfully urge the Department of Labor to withdraw the Proposed Rule. Moreover, we encourage the Department to clarify that where ESG issues present material financial or economic risks or opportunities, fiduciary duties *compel* their consideration in investment decisions.

Since 1989, the CIEL has used the power of law to protect the environment, promote human rights, and ensure a just and sustainable society. CIEL pursues its mission through legal research and advocacy, education and training, with a focus on connecting global challenges to the experiences of communities on the ground. In the process, we build and maintain lasting partnerships with communities and non-profit organizations around the world.

For almost a decade, CIEL has been studying the relationship between climate change and financial risk. Most relevant to this Proposed Rule is CIEL's work on fiduciary duty for public-sector pension fund trustees. In 2016, CIEL published a report *Trillion Dollar Transformation: Fiduciary Duty, Divestment, and Fossil Fuels in an Era of Climate Risk*,[1] which analyzed how climate-related financial risk implicated six enumerated fiduciary obligations for public-sector pension fund trustees. Paired with a financial analysis from Mercer,[2] CIEL's

[1] See CENTER FOR INTERNATIONAL ENVIRONMENTAL LAW, TRILLION DOLLAR TRANSFORMATION, FIDUCIARY DUTY, DIVESTMENT, AND FOSSIL FUELS IN AN ERA OF CLIMATE RISK (2016), http://www.ciel.org/wp-content/uploads/2016/12/Trillion-Dollar-Transformation-CIEL.pdf.
[2] *See* MERCER, TRILLION DOLLAR TRANSFORMATION: A GUIDE TO CLIMATE CHANGE INVESTMENT RISK MANAGEMENT FOR US PUBLIC DEFINED BENEFIT PLAN TRUSTEES (2016),

report concluded that climate-related financial risk was relevant to the prudent exercise of fiduciary duty and pension fund trustees should conduct robust evaluations of climate-related risk present in their portfolios on an ongoing basis. Since the publication of these reports, we have been in active discussion with pension fund trustees, financial analysts, legislators and other actors concerning the implementation of climate-related investment portfolio risk analyses. Given this history and continued work in the field of fiduciary duty and climate-related financial risk, CIEL has expertise relevant to, and an interest in, the Proposed Rule.

We urge withdrawal of the Proposed Rule for several reasons. First, the concern over inappropriate use of ESG-themed investing or confusion about its nature – the concern articulated as the motivating factor for this rulemaking[3] – is unsubstantiated. Evidence indicates that the integration of ESG factors in investment strategies increases returns and reduces risk – not the other way around. In codifying a presumption against ESG investment, erecting additional barriers to investment in ESG funds, and expressly prohibiting ESG funds as the default option for defined-benefit plans, the Proposed Rule would have the effect of discouraging or outright disabling fiduciaries from making investment decisions that would benefit plan holders. The documentation requirements and revised tie-breaking analysis required under the Proposed Rule would likely have the effect of chilling ESG-themed investing in defined-benefit ERISA plans. Moreover, the Rule would directly prohibit fiduciaries of defined-contribution plans from freely and fully exercising their prudential judgment in selecting investments. As such, we encourage the Department to withdraw this Rule or substantially modify it so as to encourage the active consideration of ESG factors in investing.

The Concern That Rising ESG Investing Harms ERISA Plan Participants Is Not Supported by Evidence

The Proposed Rule in its totality appears to be animated by two assumptions: (1) that ESG-themed investments are being chosen by pension fund fiduciaries for primarily non-pecuniary reasons and (2) that those investments negatively impact ERISA plan participants. However, the Department puts forward minimal evidence that fund fiduciaries are choosing funds for non-pecuniary reasons and *no* evidence that ESG investments are negatively affecting ERISA plans' "financial returns and the interests of plan participants and beneficiaries"—the very considerations the Department emphasizes as "paramount."[4] To the contrary, there is ever-accumulating evidence that incorporating ESG factors into investment decisions is likely in the best interest of ERISA plan participants. The Department should not be seeking to dissuade fiduciaries from incorporating ESG factors into their investing, but rather clarifying the importance and appropriateness of doing so when those factors are material.

The Department's notice indicates that "[t]his proposed regulation is designed in part to make clear that ERISA plan fiduciaries may not invest in ESG vehicles when they understand an underlying investment strategy of the vehicle is to subordinate return or increase risk for the purpose of nonpecuniary objectives."[5] The section outlining the purpose of the regulatory action, however, provides no evidence that this behavior is common, much less widespread. In fact, according to the Department's notice, ERISA funds are considerably less likely than the market overall to be invested in ESG plans, suggesting slower adoption of ESG strategies by ERISA fiduciaries not overzealousness. Finally, the Department's citation to a study of individual investor behavior in the Netherlands[6] is simply not probative of the conduct of ERISA fiduciaries who are bound by law to act solely in the financial interests of plan participants.

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https://www.mercer.com/content/dam/mercer/attachments/private/nurture-cycle/gl-2016-responsible-investments-a-guide-to-climate-change-investment-risk-management-for-us-public-defined-benefit-plan-trustees-mercer.pdf.

[3] *See* Financial Factors in Selecting Plan Investments, 85 Fed. Reg. 39,113, 39,116 (proposed June 30, 2020) (to be codified at 29 C.F.R. pt. 2,550) ("The Department is concerned, however, that the growing emphasis on ESG investing may be prompting ERISA plan fiduciaries to make investment decisions for purposes distinct from providing benefits to participants and beneficiaries and defraying reasonable expenses of administering the plan.").

[4] *Id.* at 39,114.

[5] *See id.* at 39,115-16.

[6] *See id.* at 39,121, & n. 36.

Integrated ESG Vehicles Have Been Demonstrated to Outperform Traditional Funds

As the Department notes, ESG investing does not necessarily imply lower returns or greater risk in a portfolio.[7] Rather, investment strategies that incorporate environmental, social, and governance risk factors into portfolio selection can reduce risk or increase returns.

Climate change provides a clear illustration of the importance of considering ESG factors in investment strategies. It is generally accepted in the financial sector that climate change poses material financial risk to investment portfolios.[8] As CIEL has argued, due to its clear materiality, failing to consider climate-related financial risk in developing pension investment strategy is likely a violation of the duty of prudence,[9] in particular the duty to inquire, the duty to monitor, and the duty of impartiality.

While climate change poses a clear example, other ESG factors pose risks to investment portfolios as well. Recent analyses from Morningstar,[10] Blackrock,[11] S&P Global[12] add to a growing body of research indicating that ESG-themed investing overall, when pursued to maximize financial returns and minimize risk, either outperforms or is more resilient than traditional, universal-owner portfolios.
Because ESG factors may present material financial risks and opportunities for investors, the Department should not be erecting barriers to the consideration of such factors. To the contrary, the Department should consider clarifying that where ESG factors do present material financial risk, fund fiduciaries have an obligation to consider them as they would any other material financial risk. This Proposed Rule, however, is likely to have the opposite effect.

The Proposed Rule Is Likely to Chill Prudent ESG Investing for Defined Benefit Plans

To the extent that the Proposed Rule discourages ESG-themed investment by communicating a presumption that such investments are imprudent and/or by heightening documentation requirements for fiduciaries who make such investments, it is likely to reduce returns for beneficiaries in the long run. Fiduciary obligations under ERISA are already "the highest known to the law."[13] There is no reason to believe that the current doctrine of fiduciary duty is insufficient to protect beneficiaries, as sacrificing returns or accepting unnecessary additional risks is already expressly prohibited.[14] Moreover, as discussed above, there is no

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[7] *See id.* at 39,116 ("As the Department has recognized in its prior guidance, there may be instances where factors that sometimes are considered without regard to their pecuniary import—such as environmental considerations—will present an economic business risk or opportunity that corporate officers, directors, and qualified investment professionals would appropriately treat as material economic considerations under generally accepted investment theories.").

[8] *See, e.g.*, MERCER, INVESTING IN A TIME OF CLIMATE CHANGE (2015), https://www.mercer.com/content/dam/mercer/attachments/global/investments/mercer-climate-change-report-2015.pdf; Letter to clients, Laurence D. Fink et al., Global Executive Committee, Blackrock, Sustainability as BlackRock's New Standard for Investing (Jan. 14, 2020), https://www.blackrock.com/corporate/investor-relations/blackrock-client-letter; TASK FORCE ON CLIMATE-RELATED FINANCIAL DISCLOSURES, FINAL REPORT (2017), https://www.fsb-tcfd.org/publications/final-recommendations-report/.

[9] *See* CENTER FOR INTERNATIONAL ENVIRONMENTAL LAW, *supra* note 1.

[10] *See* Chris Sloley, *There's No Performance Penalty for ESG Funds – But Fees Matter*, CITYWIRESELECTOR.COM (June 23, 2020), https://citywireselector.com/news/there-s-no-performance-penalty-for-esg-funds-but-fees-matter/a1371243.

[11] *See* BLACKROCK, SUSTAINABLE INVESTING: RESILIENCE AMID UNCERTAINTY (2020), https://www.blackrock.com/corporate/literature/investor-education/sustainable-investing-resilience.pdf.

[12] See Michael Copley, Esther Whieldon & Robert Clark, ESG funds remain relative safe havens in coronavirus downturn, S&P GLOBAL PLATTS (May 19, 2020), https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/esg-funds-remain-relative-safe-havens-in-coronavirus-downturn-58679570

[13] *Donovan v. Bierwirth*, 680 F.2d 263, 272 n. 8 (2d Cir. 1982).

[14] *See* Field Assistance Bulletin No. 2018-01, John J. Canary, Director of Regulations and Interpretations, Employee Benefits Security Admin., U.S. Dept. of Labor (Apr. 23, 2018), https://www.dol.gov/agencies/ebsa/employers-and-

evidence that ERISA fiduciaries are overeagerly pursuing ESG investment strategies which would put their beneficiaries at risk. In fact, it seems more likely that fiduciaries, out of an abundance of caution, are slower to incorporate ESG factors into their investment strategies despite growing evidence that they may positively affect returns, and thus clarifying the importance of those factors to investment performance would be an important role for the Department to play.

The Proposed Rule seeks to discourage, rather than clarify, ESG investing. Paragraph (c)(1), added ostensibly to clarify what fiduciary behaviors are appropriate, seems more reasonably designed to have a chilling effect on ESG investing. In its explanation of the purpose of the new paragraph, the Department writes: "The weight given to pecuniary ESG factors should reflect a prudent assessment of their impact on risk and return—that is, they cannot be disproportionately weighted."[15] This language reflects a skepticism toward ESG factors and concern that consideration of the economic and financial impact of ESG factors may be given too much weight.

Other additional sections of the Proposed Rule appear to exist for the same purpose. The new paragraphs (b)(1)(ii)-(iv)[16] are essentially three reiterations of the requirements of the duty of loyalty. These sections are similarly unnecessary, as the duty of loyalty is already sufficient to guide the behavior of fund fiduciaries and protect the interest of plan participants and beneficiaries.

The new requirement in paragraph (b)(2) may or may not have a chilling effect as well. Paragraph (b)(2)(ii)(D) adds a distinct requirement to compare "available alternative investments or investment courses of action."[17] While the provision does not elucidate exactly how or when such comparisons should be undertaken or what such a comparison entails, it appears designed to force a comparison of any ESG-themed fund with an unspecified number of alternatives, creating additional hurdles to ESG integration. As the Department explains: "Clarifying that an investment or investment course of action must be compared to available alternatives is an important reminder that fiduciaries must not let non-pecuniary considerations draw them away from an alternative option that would provide better financial results."[18] As will be discussed below, however, it is not clear whether this requirement would apply equally in both directions – that is, that traditional investment funds must be compared to ESG-themed funds as well, in all cases. If so, that would be a welcome and appropriate change to ERISA regulation. Reading this language in the broader context of the Proposed Rule, however, suggests that it is not intended to encourage consideration of ESG funds as "alternatives" to traditional investment funds. As such, the new comparison requirement is likely to present an unclear and asymmetric obstacle for ESG-themed investments, further chilling the incorporation of ESG approaches.

The new paragraph (c)(2) also reflects skepticism of ESG-themed investments and would codify a presumption against such investments, in favor of status quo investment portfolios. The paragraph introduces a documentation requirement for fiduciaries who would choose an investment approach for non-pecuniary reasons, including ESG factors, despite their economic equivalence with "alternative" investments.[19] According to the Department, this paragraph is intended to "safeguard against the risk that fiduciaries will improperly find economic equivalence and make decisions based on non-pecuniary factors without a proper analysis and evaluation."[20] The new requirement again seeks to guard against a phenomenon

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advisers/guidance/field-assistance-bulletins/2018-01 ("In IB 2015-01, the Department reiterated its longstanding view that, because every investment necessarily causes a plan to forego other investment opportunities, plan fiduciaries are not permitted to sacrifice investment return or take on additional investment risk as a means of using plan investments to promote collateral social policy goals.")

[15] *See* Financial Factors in Selecting Plan Investments, *supra* note 3, at 39,117.

[16] *See id.* at 39,127.

[17] *See id.*

[18] *See id.* at 39,117.

[19] *See id.* at 39,117-18.

[20] *See id.* at 39,117-18

that the Department cites as justification for the Proposed Rule without any evidence or substantiation. Moreover, the requirement introduced by paragraph (c)(2) is unreasonably one-sided. The provision is designed to protect against mal-intent on the part of fund fiduciaries who elect to invest in ESG funds as a tie-breaker, but does not require any documentation if the fiduciary elects *not* to invest in the ESG fund, despite finding it economically equivalent to an alternative investment vehicle. This one-sided requirement again is likely to chill investment in ESG-themed funds with no clear benefit to plan participants.

The Proposed Rule Is Unnecessary and Counterproductive with Regard to Selection of Qualified Default Investment Alternatives for Defined Contribution Plans

The Proposed Rule would unduly prohibit the inclusion of ESG-themed investments as part or all of Qualified Default Investment Alternatives (QDIA), even when those investments are expected to outperform non-ESG alternatives. This prohibition will make it more difficult for fiduciaries to provide the best available investment options for their beneficiaries. Moreover, by prohibiting ESG-themed investments from being QDIAs, the Department is both putting its thumb on the scales for the status quo and contradicting its own analysis in its proposal.

A QDIA is the plan in which employees are automatically enrolled if they choose not to make an election among several options for their self-directed retirement accounts. The proposed rule would disallow investment plans that contained any ESG-themed investing from being Qualified Default Investment Alternatives (QDIA) for defined contribution plans, although it would allow ESG-themed plans to exist among a menu of options. Nonetheless, as noted in the proposal, the QDIA is important for those beneficiaries who may not be comfortable making their own investment decisions.

This prohibition is unnecessary to achieve the purported goals of the Department, conflicts with the other provisions of the rule, and is counter to the best interests of ERISA plan participants. The rule as written goes far beyond the rationale for prohibiting ESG-themed QDIAs. The proposal states: "The Department does not believe that investment funds whose objectives include non-pecuniary goals—*even if selected by fiduciaries only on the basis of objective risk-return criteria consistent with paragraph (c)(3)*—should be the default investment option in an ERISA plan."[21] But the actual text of the Proposed Rule expands beyond this, including a prohibition on even those funds that incorporate ESG factors *only* as pecuniary factors, and only for pecuniary reasons.[22]

Even if it were restricted to those ESG funds that include non-pecuniary goals among their objectives, the provision presents fund fiduciaries with a conflict. Including an ESG fund in whole or in part in a QDIA would be prohibited even if that were the most prudent investment for the fund fiduciary to select. As described above, ESG factors present material risks and opportunities to investors, and ESG funds have the potential to outperform traditionally-constructed funds. Such a blanket prohibition therefore risks binding the hands of defined-contribution fund fiduciaries regardless of how clear the case for ESG investing becomes.

The proposal acknowledges the limited penetration of ESG-themed investing into DC plans with individual accounts, citing one survey that estimated only 0.1% of DC plan assets are invested in ESG funds.[23] Given the potential outperformance of ESG-themed funds over traditional investments, the Department should be less concerned with overzealous and irresponsible ESG investing – a trend which it has not demonstrated

[21] *See id.* at 39,119 (emphasis added).
[22] *See id.* at 39, 127 (defining ESG funds which would be prohibited from QDIA eligibility as "prudently selected, well managed, and properly diversified investment alternatives that include one or more environmental, social, corporate governance, or similarly oriented assessments or judgments in their investment mandates, or that include these parameters in the fund name").
[23] *See id.* at 39,121 ("In terms of the actual utilization of ESG options, one survey indicates that about 0.1 percent of total DC plan assets are invested in ESG funds.").

exists or is likely to exist – and rather consider how to more effectively encourage fiduciaries to incorporate the most advanced and profitable investing techniques available, including those that consider ESG factors.

The Department Should Clarify that ESG Factors Should Always Be Considered for Investment Decisions

As CIEL argues, all pension fund fiduciaries should be conducting robust evaluations of climate-related financial risk in their portfolios.[24] Given the positive financial performance of ESG investments, and the growing consensus that environmental, social, and governance risks – including but not limited to those posed by climate change – are material financial factors affecting investment outcomes, it would be appropriate for the Department to clarify that all fiduciaries should be comparing traditional investment approaches with those that incorporate climate and other ESG factors.

Conclusion

The Proposed Rule is unnecessary in light of the stringent fiduciary requirements already in ERISA. Given the mounting evidence of the importance of environmental, social, and governance factors to the financial performance of investment portfolios, the Department should not be erecting barriers to ESG investing, but rather clarifying its clear important role. For these reasons, we respectfully urge the Department to withdraw this Proposed Rule, or significantly modify it to clarify that environmental, social, and governance factors are material risks and that fund fiduciaries should evaluate them in developing their investment strategies.

Sincerely,

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[24] *See* CENTER FOR INTERNATIONAL ENVIRONMENTAL LAW, *supra* note 1.