Council of Institutional Investors®
The voice of corporate governance

Via Electronically

July 28, 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
Attention: Financial Factors in Selecting Plan Investments Proposed Regulation

Re: RIN 1210-AB95

Dear Secretary Scalia:

I am writing on behalf of the Council of Institutional Investors (CII), a nonprofit, nonpartisan association of U.S. public, corporate and union employee benefit funds, other employee benefit plans, state and local entities charged with investing public assets, and foundations and endowments with combined assets under management of approximately $4 trillion. Our member funds include major long-term shareowners with a duty to protect the retirement savings of millions of workers and their families, including public pension funds and defined contribution plans with more than 15 million participants – true "Main Street" investors through their funds. Our associate members include non-U.S. asset owners with about $4 trillion in assets, and a range of asset managers with more than $40 trillion in assets under management.[1]

The purpose of this letter is to provide you with our perspectives on the Department of Labor (DOL) "proposed amendments to the 'Investment duties' Regulation under Title I of the Employee Retirement Income Security Act of 1974, as amended (ERISA),[2] to confirm that ERISA requires plan fiduciaries to select investments and investment courses of action based solely on financial considerations relevant to the risk adjusted economic value of a particular investment or investment course of action" (Proposed Rule).[3]

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[1] For more information about the Council of Institutional Investors ("CII"), including its board and members, please visit CII's website at http://www.cii.org.

[2] Employee Retirement Income Security Act §§2-1052, 29 U.S.C. §§1001-1191c (1974), *available at* https://www.law.cornell.edu/uscode/text/29/chapter-18.

[3] Financial Factors in Selecting Plan Investments, RIN 1210-AB95, 85 Fed. Reg. 39,113 (Dep't of Labor June 30, 2020), https://www.federalregister.gov/documents/2020/06/30/2020-13705/financial-factors-in-selecting-plan-investments.

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CII is a "broad tent"; members have varying views on environmental, social, and corporate governance (ESG) issues. We, however, believe the Proposed Rule demonstrates an unjustified skepticism by DOL about ERISA plans' ESG investing practices without adequately defining what those practices are or why they should be discouraged.

We also believe the Proposed Rule would create significant burdens of proof for investment approaches that emphasize investment risk and opportunities around ill-defined ESG matters, without subjecting funds that dismiss or minimize ESG risks and opportunities (including avoidance for ideological reasons) to the same burdens. We also believe the Proposed Rule would impose new recordkeeping costs for plan fiduciaries that are likely much higher than DOL estimates, exceeding the alleged benefits of the proposed change. We, therefore, respectfully oppose the Proposed Rule.

Lack of Evidence Existing Requirements are Inadequate

We note DOL describes the purpose of the Proposed Rule "to set forth a regulatory structure to assist ERISA fiduciaries in navigating these ESG investment trends and to separate the legitimate use of risk-return factors from inappropriate investments that sacrifice investment return, increase costs, or assume additional investment risk to promote non-pecuniary benefits or objectives."[4] Given the stated purpose of the Proposed Rule, one might expect DOL to more clearly define what specific types of ESG investment trends it is concerned about and provide evidence that ERISA fiduciaries are making those investments on the basis of non-pecuniary criteria. Instead, DOL shares two qualified "concerns" as evidence for the Proposed Rule.

DOL's first concern is "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."[5] It is perhaps revealing that there is an absence of evidence for this, except the Proposed Rule subsequently references a 2017 study of individual mutual fund investors in the Netherlands, presumably as support for this concern.[6] The argument seems to be that attitudes of individual Dutch investors with regard to their own personal investments show what U.S. fiduciaries may be doing with regard to funds belonging to others, which is less-than-convincing.

DOL's second concern is "that *some* investment products *may be* marketed to ERISA fiduciaries on the basis of purported benefits and goals unrelated to financial performance."[7] DOL cites two

[4] 85 Fed. Reg. at 39,116; *see id.* at 39,120 (describing "non-pecuniary" as "investment decisions for purposes distinct from their responsibility to provide benefits to participants and beneficiaries and defraying reasonable plan administration expenses").
[5] *Id.* at 39,116 (emphasis added).
[6] *See id.* at 39,120 & n.30 ("Riedl and Smeets' research on individual investors in the Netherlands shows that financial motives play less of a role than social preferences and social signaling in explaining decisions to invest in 'socially responsible' mutual funds.").
[7] *Id.* at 39,116 (emphasis added).

newspaper articles in support of this concern.[8] The articles identify at least two related categories of information that appear to have been largely overlooked or disregarded in the development of the Proposed Rule: (1) The "G" or corporate governance element of ESG has "long been a major part of ordinary fund management";[9] and (2) the growing body of evidence that certain other ESG investments can also be pecuniary and can actually outperform their non-ESG equivalents.[10]

<u>Corporate governance investments can be pecuniary</u>

The Proposed Rule includes over a dozen references to "corporate governance."[11] None of those references, however, identify or even acknowledge the differences between the "G" and the "E" and "S" in "ESG."

We note, for example, the recent comments of Commissioner Elad L. Roisman of the Securities and Exchange Commission:

> I often wondered how the three concepts of environmental, social, and governance matters got lumped together. When I looked into it, I saw that it was relatively recently that socially responsible investors, focusing on "E" and "S" issues, rebranded to add "governance" to the mix, a component that had research tying it to firm value.[12]

While there is also a growing body of research tying certain "E" and "S" issues to firm value,[13] for more than 15 years the "G" or corporate governance[14] element has been widely viewed by researchers and investors as an important factor when managing plan portfolios.[15] We, therefore,

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[8] *Id.* at n.19; James Mackintosh, A User's Guide to the ESG Confusion, Wall St. J. (Nov. 12, 2019) (on file with CII); Mark Miller, Bit by Bit, Socially Conscious Investors Are Influencing 401(k)'s, N.Y. Times (Sept. 27, 2019) (on file with CII).
[9] James Mackintosh, A User's Guide to the ESG Confusion, Wall St. J.
[10] *See* Mark Miller, Bit by Bit, Socially Conscious Investors Are Influencing 401(k)'s, N.Y. Times ("A growing body of evidence supports . . . [E.S.G. investments] outperform their non-E.S.G. equivalents – in some cases, by substantial margins.").
[11] *See* 85 Fed. Reg. at 39,114, 39,115, 39,116, 39,117, 39,118, 39,119, 39,120, 39,122, 39,127.
[12] Commissioner Elad L. Roisman, Keynote Speech at the Society for Corporate Governance National Conference (July 7, 2020), https://www.sec.gov/news/speech/roisman-keynote-society-corporate-governance-national-conference-2020.
[13] *See, e.g.,* Rhonda Brauer and Glenn Davis, Sustainability Reporting Frameworks: A Guide For CIOs, CII-REF 8 (Sept. 2019), https://7677c7b7-7992-453f-8d12-74ccbdbee23c.filesusr.com/ugd/72d47f_e00c47786e17471fb3b8222e78427935.pdf ("the [ESG] research generally finds that factors that would be deemed financially material by SASB or TCFD correlate with superior financial results, which benefit long-term investors").
[14] *See generally* CII Research and Education Fund, What is Corporate Governance? Why is it Important to You? (2018), https://www.ciiref.org/whatiscorporategovernance (providing a brief introduction to the basics of corporate governance).
[15] *See* Eddie van der Walt, In ESG Investing, Maybe the Emphasis is on the G, Bloomberg (July 10, 2020) (on file with CII) ("Governance data have been compiled longer and are easier to quantify, which rids the investor of some of

believe it is particularly anomalous for DOL to issue a Proposed Rule that limits or burdens the ability of plan fiduciaries to exercise a judgment that good corporate governance practices[16] can enhance or protect returns.[17] It is also anomalous DOL does not impose those same limits and burdens on plan fiduciaries whose investment choices *ignore* good corporate governance practices.

DOL acknowledges that "[d]ysfunctional corporate governance can . . . present pecuniary risk that a qualified investment professional would appropriately consider on a fact-specific basis."[18] However, DOL fails to acknowledge the consequential body of research finding that corporate governance can have a material effect on the return or risk of an investment. At a minimum, we believe DOL should have evaluated the following empirical research before incorporating corporate governance into the provisions of the Proposed Rule:

- John Core, Robert W. Holthausen and David F. Larcker, Corporate Governance, CEO Compensation, and Firm Performance, *Journal of Financial Economics* (February 1997). Finding that "firms with weaker governance structures have greater agency problems; that CEOs at firms with greater agency problems receive greater compensation; and that firms with greater agency problems perform worse."[19]
- Mark S. Beasley, Joseph V. Carcello, Dana R. Hermanson, and Paul D. Lapides, Fraudulent Financial Reporting: Consideration of Industry Traits and Corporate Governance Mechanisms, *Accounting Horizons* (December 2000). Finding that "the sample fraud companies have very weak governance mechanisms relative to no-fraud industry benchmarks."[20]
- Paul A. Gompers, Joy L. Ishii, & Andrew Metrick, Corporate Governance and Equity Prices, *Quarterly Journal of Economics* (February 2003). Finding "that firms with stronger shareholder rights had higher firm value, higher profits, higher sales growth . . . ."[21]

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the tracing issues in ESG [and] [a]s far back as 2003, the Quarterly Journal of Economics carried a study by Gompers, Ishii and Metrick of Harvard, Stanford and Yale, that used a governance index to show improved returns from firms that offered greater shareholder rights."); James Mackintosh, A User's Guide to the ESG Confusion, Wall St. J.. One could argue that investment approaches that heavily weigh managerial quality are "G" funds, and there is a long lineage for such approaches.

[16] *See generally* Council of Institutional Investors, Corporate Governance Policies (updated Mar. 10, 2020), https://www.cii.org/files/03_10_20_corp_gov_policies(1).pdf (representing corporate governance best practices).

[17] *See, e.g.*, Martin Lipton et al., DOL Proposes New Rules Regulating ESG Investments, Harv. L. Sch. F. Corp. Gov. (July 7, 2020), https://corpgov.law.harvard.edu/2020/07/07/dol-proposes-new-rules-regulating-esg-investments/ ("It [proposed rule] is particularly anomalous, especially in these times, for the DOL to limit or unduly burden the ability of plan fiduciaries to exercise a judgment that items like good corporate governance, effectively navigating energy transitions or operating in a sustainable manner can enhance or protect returns.").

[18] 85 Fed. Reg. at 39,661.

[19] John Core et al., Corporate Governance, CEO Compensation, and Firm Performance, 51 J. Fin. Econ., Issue 3, at 371 (Feb. 1997), *available at* https://www.sciencedirect.com/science/article/pii/S0304405X98000580.

[20] Mark S. Beasley et al., Fraudulent Financial Reporting: Consideration of Industry Traits and Corporate Governance Mechanisms, 14 Acct. Horizons 441 (Dec. 2000), https://aaapubs.org/doi/10.2308/acch.2000.14.4.441.

[21] Paul Gompers et al., Corporate Governance and Equity Prices, 118 Q. J. Econ., No. 1, at 107 (Feb. 2003), *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=278920.

- K. J. Martijn Cremers and Vinay B. Nair, Governance Mechanisms and Equity Prices, *Journal of Finance* (December 2005). Finding that "internal and external governance mechanisms are complements in being associated with long-term abnormal returns."[22]
- Lucian Bebchuk, Alma Cohen and Allen Ferrell, What Matters in Corporate Governance? *Review of Financial Studies* (February 2009). Finding that "staggered boards, limits to shareholder bylaw amendments, poison pills, golden parachutes, and supermajority requirements for mergers and charter amendments [are] . . . associated with economically significant reductions in firm valuation as well as large negative abnormal returns during the 1990–2003 period."[23]
- Vicente Cuňat, Mireia Gine, and Marie Guadalupe, The Vote is Cast: The Effect of Corporate Governance on Shareholder Value, *The Journal of Finance* (October 2012). Finding that "passing a [corporate governance] proposal leads to significant positive abnormal returns."[24]

Environmental and social investments can also be pecuniary

While we believe DOL should have considered corporate governance separately from the "E" and "S" of ESG when developing the Proposed Rule, investors are increasingly coalescing around the notion that certain environmental and social factors also can influence long-term financial performance.[25] DOL appears to acknowledge this for at least some environmental related investments by stating:

> [A] company's improper disposal of hazardous waste would likely implicate business risks and opportunities, litigation exposure, and regulatory obligations. These would be appropriate economic considerations that qualified investment professionals would treat as material under generally accepted investment theories.[26]

The Proposed Rule, however, fails to identify and weigh the growing body of evidence linking certain environmental and social policy matters with large potential impacts on long-term shareholder value.[27] The Proposed Rule also fails to recognize that investors increasingly view

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[22] K. J. Martijn Cremers & Vinay B. Nair, Governance Mechanisms and Equity Prices, 60 J. Fin., Issue 6, at 2859 (Dec. 2005), *available at* https://onlinelibrary.wiley.com/doi/full/10.1111/j.1540-6261.2005.00819.x.
[23] Lucian Bebchuk et al., What Matters in Corporate Governance?, 22 Rev. Fin. Stud., Issue 2, at 783 (Feb. 2009), *available at* https://academic.oup.com/rfs/article-abstract/22/2/783/1596611.
[24] Vicente Cuňat et al., The Vote is Cast: The Effect of Corporate Governance on Shareholder Value, 67 J. Fin., Issue 5, at 1943 (Oct. 2012), *available at* https://afajof.org/issue/volume-67-issue-5/.
[25] *See, e.g.*, Rhonda Brauer and Glenn Davis, Sustainability Reporting Frameworks: A Guide For CIOs, CII-REF at 3 ("As investors increasingly coalesce around the notion that ESG factors can influence long-term financial performance, demand has grown for ESG information that is useful to investment decision-making, proxy voting, engagement or a combination of all three.").
[26] 85 Fed. Reg. at 39,116.
[27] *See* Letter from Kenneth A. Bertsch, Executive Director, Council of Institutional Investors et al. to Vanessa A. Countryman, Secretary, Securities and Exchange Commission 53 n.82 (Jan. 30, 2019),

certain of those matters as complementary to their fiduciary duties of reducing risk and improving investment outcomes.[28]

More broadly, we generally agree with the following observations of Wachtell, Lipton, Rosen & Katz in response to the Proposed Rule:

> Numerous sophisticated investors have indicated that their ESG investments, social benefits notwithstanding, are fundamentally driven by expected financial returns, including considerations regarding long-term value, opportunity and risk, and have cited studies published over the past five years indicating that an ESG perspective can improve performance, including studies that show ESG-focused indexes have matched or exceeded returns of their standard counterparts, with comparable volatility, and investors who screened for ESG factors could have avoided 90% of S&P 500 bankruptcies from 2005 to 2015 and that S&P 500 companies in the top 25% by ESG ratings experienced lower future earnings-per-share volatility than those in the bottom 25%.
>
> Amid the current pandemic, ESG funds have demonstrated outperformance relative to the market and continue to attract strong inflows, which appears to reflect growing investor recognition of the importance of ESG in risk management and mitigation, as well as the view that addressing ESG issues promotes long-term value creation.[29]

We also believe DOL should consider the relevant evidence contained in the recent U.S. Government Accountability Office report entitled "Disclosure of Environment, Social, and

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https://www.cii.org/Files/issues_and_advocacy/correspondence/2020/20201030%2014a-8%20comment%20letter%20FINAL.pdf ("A range of issues have been raised through shareholder proposals over the years, including a number of environmental and social policy matters with large potential impacts on long-term shareholder value [and] [t]here is huge literature on these subjects, with a range of views [and] [a] particularly good review of the literature is Roy Henriksson, Joshua Livnat, Patrick Pfeifer, Margaret Stumpp, and Gloria Zeng, 'ESG Literature Review,' QMA (Quantitative Management Associates LLC) and Stern School of Business Administration, New York University, June 2018, at https://www.qma.com/assets/pdf/QMA_ESG_Literature_Review_June2018.pdf ."); *see also* Era Aganosti et al., E&S Disclosure Trends in SEC Filings 2018-2019, White & Case (June 26, 2019), https://www.whitecase.com/publications/alert/es-disclosure-trends-sec-filings-2018-2019 ("Forty-seven of the companies surveyed (or 94 per cent) increased their E&S disclosures in Form 10-Ks and proxy statements between 2018 and 2019.").

[28] Rhonda Brauer and Glenn Davis, Sustainability Reporting Frameworks: A Guide For CIOs, CII-REF at 27 ("Investors increasingly view ESG factors as an expansion of their traditional risk management processes and complementary to their fiduciary duties to their beneficiaries and clients.").

[29] Martin Lipton et al., DOL Proposes New Rules Regulating ESG Investments, Harv. L. Sch. F. Corp. Gov.; *see, e.g.*, Letter from Robert A.G. Monks, Chairman & Nell Minow, Vice Chair, ValueEdge Advisors to Assistant Secretary Preston Rutledge, ESBVA, Department of Labor 5-8 (July 20, 2020) (on file with CII) (providing examples of the "great deal of evidence about the increasing sophistication of institutional investors in using ESG indicators to evaluate risk and return and the increasing importance of those factors.").

Governance Factors and Options to Enhance Them" (GAO Report).[30] For example, the GAO Report stated:

> Institutional investors with whom we spoke generally agreed that ESG issues can have a substantial effect on a company's long-term financial performance. All seven private asset managers and representatives at five of seven public pension funds said they seek ESG information to enhance their understanding of risks that could affect companies' value over time. . . . [I]nvestors with whom we spoke primarily used ESG information to assess companies' long-term value . . . ."[31]

Analysis of Costs is Understated

The provisions of the Proposed Rule would require specific documentation of a tiebreaker justification[32] and for the selection and monitoring of an investment alternative in a 401(k) plan that includes ESG in its mandate or fund names.[33] We believe those documentation costs would be significant and burden the ability of plan fiduciaries to select appropriate investments based on corporate governance and other pecuniary ESG factors.

We note that the Proposed Rule states that the "documentation requirement . . . would impose little, if any, additional cost on individual account plan fiduciaries, because they already commonly document and maintain records about their investment choices as a best practice and potential shield from litigation risk."[34] The Proposed Rule also states DOL "does not expect [the documentation] requirements to impose a significant increase in hourly burden or cost because the Department believes that truly indistinguishable alternative investment options should occur very rarely in practice, if at all and defined contribution plans are already documenting their decisions when selecting investment alternatives for their participant directed investment platforms."[35] We note DOL's "belief" that "truly indistinguishable alternative investment options" are rare is simply an assertion, not backed by substantial evidence.[36]

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[30] U.S. Gov't Accountability Office, GAO-20-530, Public Companies, Disclosure of Environmental, Social, and Governance Factors and Options to Enhance Them (July 2020), https://www.gao.gov/assets/710/707949.pdf.
[31] *Id.* at 9 (emphasis added and footnote omitted).
[32] *See* 85 Fed. Reg. at 39,117 ("Paragraph (c)(2) guides application of the 'all things being equal'' test by requiring fiduciaries to adequately document any such occurrences.").
[33] *Id.* at 39,122 ("individual account plan fiduciaries will need to document their selections of investment alternatives that include one or more ESG or similarly oriented assessments or judgments in their investment mandates or that include these parameters in the fund name"); *see, e.g.*, Martin Lipton et al., DOL Proposes New Rules Regulating ESG Investments, Harv. L. Sch. F. Corp. Gov. ("Specific documentation would be required for the tiebreaker justification and for the selection and monitoring of an investment alternative in a 401(k) plan that includes ESG in its mandate or fund name.").
[34] 85 Fed. Reg. at 39,112.
[35] *Id*. at 39,123.
[36] *Id.*

The Proposed Rule goes on to provide the following quantification of the documentation costs:

> The Department estimates that plan fiduciaries and clerical staff will each expend, on average, 2 hours of labor to maintain the needed documentation. This results in an annual burden estimate of 600 hours, with an equivalent cost of $56,818 for DB plans and DC plans with ESG investments that are not participant directed.[37]

As indicated, we believe DOL's estimated costs of complying with the proposed documentation requirements are significantly understated. On this point, we generally share the following reported views of Chantel Sheaks, the U.S. Chamber of Commerce's retirement policy director, as referenced in a Bloomberg article:

> The Labor Department missed the mark on this one, in Sheaks' opinion.
> "The DOL has created more of a problem than what existed," she said, poking holes in the administration's projected compliance costs (about $57,000) and the time required (two hours) for the additional record keeping.
> "Anyone who spends that little time likely would have breached their fiduciary duty with respect to a plan's investment," she said. "The DOL also ignores that plans will need to seek legal review of such documentation which will add significantly to the cost."[38]

Qualified Default Investment Alternative (QDIA) Prohibition Has No Rationale

We oppose the Proposed Rule provision that prohibits a 401(k) plan from providing the QDIA with an ESG component even if that investment alternative satisfies the proposed pecuniary factor requirements.[39] That provision, perhaps the most significant of the changes in the Proposed Rule,[40] would appear to prevent a plan fiduciary from offering an ESG-themed fund with the name ESG even as a small component of the QDIA.[41] We believe DOL has not explained why

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[37] *Id.* at 39,124.

[38] Warren Rojas, Legal Battles Likely Over Trump's ESG Crackdown, Advisors Say, Bloomberg L. (June 24, 2020) (on file with CII); *see, e.g.*, Martin Lipton et al., DOL Proposes New Rules Regulating ESG Investments, Harv. L. Sch. F. Corp. Gov. ("The extensive scope of criteria that the DOL considers problematic will also likely result in increased costs and fees as plan fiduciaries seek to filter for these criteria.").

[39] *See* 85 Fed. Reg. at 39,127 ("(iii) the environmental, social, corporate governance, or similarly oriented investment mandate alternative is not added as, or as a component of, a qualified default investment alternative described in 29 CFR 2550.404c-5.").

[40] *See, e.g.,* Martin Lipton et al., DOL Proposes New Rules Regulating ESG Investments, Harv. L. Sch. F. Corp. Gov. ("Most significantly, the proposed rules would prohibit a 401(k) plan from providing a qualified default investment alternative . . . with an ESG component, no matter how small, even if that investment alternative satisfies the pecuniary factor requirements.").

[41] *See, e.g.,* Rebecca Moore, Compliance, DOL ESG Proposal Throws a Cloud Over Prior Guidance, PlanSponsor (June 30, 2020), https://www.plansponsor.com/in-depth/dol-esg-proposal-throws-cloud-prior-guidance/ (quoting Steven Rabitz, a partner at Dechert in New York City: "'With respect to QDIAs, it says your ESG-themed fund with the name ESG in it is problematic in the QDIA or even in one of its components.'").

the ESG name alone disqualifies an investment from the QDIA, let alone as a small component of the QDIA.

Duty of Loyalty is Circular

We oppose the Proposed Rule's provisions regarding the plan fiduciaries duty of loyalty because they are circular.[42] More specifically, the provisions include a catch-all requirement that the fiduciaries' plan decisions must have "otherwise complied with the duty of loyalty [and the fiduciary] has acted accordingly."[43]

We presume that describing what a plan fiduciary must do in order to satisfy *the duty of loyalty* by requiring compliance with *the duty of loyalty* was a drafting error. Like many of the other provisions of the Proposed Rule these provisions should be revised or, more preferably, discarded.

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For all of the above reasons, CII opposes the Proposed Rule. Thank you for considering our views on this matter. Please contact me with any questions.

Sincerely,

Jeff Mahoney

Jeffrey P. Mahoney
General Counsel

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[42] *See* 85 Fed. Reg. at 39,127 ("(iv) Has not otherwise acted to subordinate the interests of the participants and beneficiaries to the fiduciary's or another's interests and has otherwise complied with the duty of loyalty; and (v) has acted accordingly.").
[43] *Id.*