December 12, 2021

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: Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights

Docket Number: EBSA-2021-0013

Docket RIN: 1210-AC03

We are grateful for the opportunity to comment on the excellent proposal from DOL/EBSA, which addresses the concerns we raised about the previous rulemakings on proxy voting and ESG investing by pension fiduciaries.

Proxy Voting and Other Rights of Share Ownership

The issue of proxy voting by pension fiduciaries has been of interest to one if the signers of this comment, Robert A.G. Monks, since before he served as the head of EBSA's predecessor agency, PWBA, in the 1980s. He had served as a fiduciary responsible for voting proxies on behalf of beneficial owners and he had unsuccessfully tried to get the government to take action when, due to conflicts of interest, the trustee of Carter Hawley Hale's ESOP supported management entrenchment of the executives who retained it over a better offer from outsiders.[1] Later, as EBSA staff is aware, CEOs who were trustees for company ERISA plans wrote letters to other CEOs asking them to vote the shares of those plans against shareholder proposals. There was no attempt to make a case for these votes based on benefit to plan participants. The letter asked for support because of the benefits of poison pills and other obstacles to market-based transactions, for

[1] We included a detailed case study of this failure of oversight in all five editions of *Corporate Governance* (Blackwell), our MBA textbook.

corporate insiders. This led to the February 23, 1988 Avon letter pointing out that proxy voting, like buy/hold/sell decisions, is a fiduciary act, and must be for "the exclusive benefit of plan participants."

Since that time, proxy voting has become an even more vital element of fiduciary obligation, and one that continues to be subject to conflicts of interest. As documented in an Investor Responsibility Research Center report in 1987 and extensively covered by Vanguard founder John Bogle in many books and articles, there are only two kinds of portfolio companies, those that are clients and those that are prospective clients.

If fund managers are trying to get 401(k) business from a company, perhaps they will think twice about voting against the CEO's pay plan. The SEC's decision to require disclosure of proxy votes by fund managers came only after a Deutsche Bank fund switched its vote after Hewlitt-Packard gave it a million-dollar fee in order to secure majority support for the Compaq merger. (That deal later led to an SEC fine,[2] a $1.2 billion write-down, and inclusion in a worst-ever tech merger list,[3] so apparently the original "no" vote was the correct one). Corporate insiders can easily find out how funds vote on proxy issues while plan participants cannot. This also helps tilt the balance toward making portfolio companies happy at the expense of plan participants.

We strongly endorse an explicit statement from EBSA making clear that proxy voting *and* exercise of all share ownership rights are governed by the fiduciary standard and must be exercised for the exclusive benefit of plan participants. We would encourage EBSA to consider requiring easily accessible disclosure of proxy voting policies and proxy votes to help pension plan participants make more informed choices and keep managers more focused on shareholder value than commercial prospects.

Clear guidance from EBSA on exercise of share ownership rights is especially important when it comes to voting proxies and other exercise of shareholder rights between the buy and the sell, including engagement with portfolio companies (shareholder proposals, meetings, and other forms of communication) and litigation. Unlike buy/sell decisions, which can be evaluated solely in terms of the costs and benefits to each fund or even each account[4], proxy voting in our gigantic capital market is sub-optimally efficient due to the collective choice problem.[5] Even multi-billion-dollar funds can be "rationally apathetic" because the cost of doing the research and analysis on any given proxy issue plus the cost of overcoming the kind of conflicts of interest described by John Bogle is likely to outweigh the marginal benefits of a "correct" proxy vote. That is, unless there are explicit standards in place making clear that exercise of share ownership rights, including proxy voting, is a fiduciary obligation, there is a significant risk of sub-optimal proxy votes.

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[2] https://www.plansponsor.com/deutsche-hit-with-750000-for-h-p-compaq-deal-conflict/?layout=print

[3] https://www.zdnet.com/article/worst-tech-mergers-and-acquisitions-hp-and-compaq/

[4] I note that while it is justifiable to make different buy/sell/hold decisions in different portfolios depending on the stated goals of each fund, the same calculus does not apply to proxy voting. As most investment managers recognize, the interest of fund clients is better served by an enterprise-wide approach to proxy voting.

[5] We highly recommend this important scholarship on a related/analogous issue. https://theshareholdercommons.com/wp-content/uploads/2018/07/Taking-a-Benefit-Stance.OXREP-ArticleSSRN.Vers1_.pdf

A "hold" decision on a security is not a license to go the beach, any more than a trustee/fiduciary responsible for real property can ignore the obligations and expenses of maintenance. Even a manager of an index fund cannot just watch a stock lose value until it drops out of the index when the benefits of engagement outweigh the costs, whether that calculation concerns an individual security or the fund as a whole.

ESG

The avalanches of corporate money, including CEO-funded dark money fake front groups,[6] fake social media profiles,[7] and fake "news" sites[8] promoting restrictions on ESG factors in making investment decisions were attempted distractions from the key omission: they were unable to provide a single example of an investment decision made by an ERISA fiduciary or any other professional fund manager that was not driven exclusively by financial considerations. This was exemplified by the comment letter from the Western Energy Alliance.

First, they claimed that they support ESG, which one might think would lead them to conclude that they should be able to attract ESG-oriented investors. On the contrary, though, they claim that they understand what ESG means better than pension fund fiduciaries, among the most sophisticated financial professionals in the world and subject to the strictest standards of care and loyalty our legal system imposes. Again, they failed to come up with a single example of a "wrong" or "non-pecuniary" or "political" investment decision by a pension fiduciary.

Here is their real issue: " We have observed how ESG advocacy has negatively affected the industry's access to capital over the last few years." What the industry is saying here is that they want pension funds to subsidize otherwise market-unworthy investments. If ERISA directed plan fiduciaries to act for the exclusive benefit of corporate insiders, that might be worth considering. But EBSA's duty is to protect pension beneficiaries, and that is the opposite of what the Western Energy Alliance and the other critics of ESG are asking for.

The industry trying to suppress a market-based shareholder response to investment risk is not even able to pretend that its position supports retirement income security or investing for the *exclusive* benefit of pension plan participants. The comment is explicit about its priorities: what essentially amounts to a subsidy by diverting pension assets into securities that would not normally qualify.

The argument they made about the legitimacy of their own ESG commitments is one they should be making to the market, not to regulators. It is not DOL's job to evaluate claims about concerns about climate change, but if it was, the assertions of self-interested industry executives should be viewed with the greatest possible skepticism, especially when they are in conflict with overwhelming evidence to the contrary.

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6 https://www.nytimes.com/2020/11/11/climate/fti-consulting.html

7 https://www.motherjones.com/environment/2020/12/these-ladies-love-natural-gas-too-bad-they-arent-real/ https://www.insider.com/oil-consultant-fake-page-to-spy-on-environmental-activists-nyt-2020-11

8 https://www.ft.com/content/e23b1e17-6a5a-4e18-bd0a-5ad289dfc05c

We recognize that ESG is still an evolving discipline. But it is not a fad. ESG has passed the tipping point. For investors, it has gone from a nice-to-have to a have-to-have. ESG is the fastest growing area of investment, with every major financial institution and every significant institutional investor having one or more ESG options. US ESG index funds reached over $250 billion in 2020. More significantly, ESG factors are permeating every aspect of even the most traditional investment vehicles. A 2020 survey of 809 institutional asset owners, investment consultants and financial advisers[9] found that 75 percent of them use ESG factors in their investment strategies, up from 70 percent in 2019. Nearly 13 percent of respondents were pension plan sponsors. Corporate executives and board members are scrambling to catch up.

There are two major factors behind the new centrality of ESG. The first is the growing recognition that current financial reporting according to GAAP is not adequate. The upheavals of the dot.com bubble, the Enron-era accounting scandals, the financial meltdown, the failed public offering of WeWork and so much more remind us that there is a reason that accounting principles are called "generally accepted" and not "certifiably accurate." GAAP is fairly good at reporting the value of hard assets and computing present value of future income. It is less reliable in evaluating the worth of today's key assets like intellectual property and not of much use in informing investors about the asset almost all companies claim is their most valuable: their employees. GAAP is structured to externalize costs off the books as much as possible, driving corporate strategy in that direction. ESG is about the information GAAP leaves out or underweights.

The second major factor is market-driven, based on demographics. Millennials and the generation that follows them are vastly more concerned with ESG issues like climate and social justice than their parents, harking back more to the boomer generation activism that led to the creation of the Environmental Protection Agency, OSHA, and other regulatory agencies devoted to health and safety concerns. As employees, consumers, and investors, they are insisting on better information and more explicit strategy relating to ESG.

The problem is that the market for ESG is far ahead of the ability to supply it. We are better at understanding the importance of ESG than we are at computing and understanding the data. There is no consensus and a lot of inconsistency in defining what ESG is. That has led to a lot of opportunistic grabs for fees and market share for services and products that are based on what can be counted, not on what counts. It has led to a lot of push-back from corporations and their service providers, including efforts to distort the market by promoting restrictions on ESG-based assessments. Th answer is not to try to ignore the growing understanding of ESG factors, just to be clear that pension fiduciaries have to evaluate them with the same due diligence they bring to other data about investment risk and return.

ESG is nothing new. In the collection of The British Museum is a blue glass jar dating back to the early 19th century. The label identifies the company and the product: East India sugar. And then, in bigger letters, it has an ESG disclosure: "not made by SLAVES." The East India Company distinguished itself from its competition in the West Indies in response to the world's first grass-roots political movement and consumer boycott. This led to the abolition of slavery in the United Kingdom more than 30 years before it took a war to stop it in the United States. ESG is sometimes similarly dismissed as a fad. While fads are very popular in finance and investing, ESG

[9] https://www.pionline.com/esg/esg-integration-grows-globally-does-gap-between-us-and-others-survey

is unlikely to disappear. It will continue to be refined, and its influence will increase. For example, the largest institutional investor in the US is Black Rock, which has announced that 100 percent of its approximately 5,600 active and advisory BlackRock strategies are ESG integrated – covering U.S. $2.7 trillion in assets. Reflecting the demand, BlackRock introduced 93 new sustainable solutions in 2020, helping clients allocate U.S. $39 billion to sustainable investment strategies, which helped increase sustainable assets by 41 percent from December 31, 2019. As it consistently has throughout its history, EBSA's assessment of pension fiduciaries making ESG investments should be based on process and due diligence rather than results.

ESG is not monolithic. It is critical to remember that ESG encompasses three enormous categories: environment, governance, and a catch-all category we call social. Each is a moving target with constantly evolving ideas about what information is relevant and reliable and each has to be evaluated separately. "Social" is the wild card in the group. Rising on the list in recent years are #metoo and #blacklivesmatter concerns, plus increasing attention on political contributions and lobbying expenditures following news stories from Judd Legum[10] and others about contributions contrary to public statements about ending funding for elected officials who supported the January 6 insurrection or to those who get poor ratings from women's groups and racial equity groups. EBSA should be careful to make sure that its rules promote rather than restrict the development of ESG metrics.[11]

ESG is never "non-pecuniary" – adjacent to or conflicting with financial goals. Again, we note that neither the Department nor any of the corporate executive and trade associations have documented a single example of a pension fiduciary making any financial trade-off in ESG-qualified investments. Quite the contrary. It is a reflection of the increasing recognition, following the dot.com collapse, the Enron era accounting failures, the security analyst corruption scandal, the financial meltdown, and many other examples, showing the inadequacy of GAAP in estimating investment risks and returns. GAAP is still based in 19th century notions and is better at estimating the value of property, equipment, and other hard assets than it is at valuing what most corporations claim is their most important asset, human capital. ESG can provide significant data about employee turnover, the resources devoted to employee development and education as well as information about compliance with regulatory risk relating to climate change and other E, S, and G issues.

To provide some context for these concerns, here are just a few of the extensive and compelling developments and evidence on ESG as a meaningful risk factor that not only can but must be a part of any fiduciary's responsibility to evaluate and act on:

1. The Environmental Protection Agency[12] published a 150-page document about coping with the debris from natural disasters across the country, which said, "Start planning for the fact that climate change is going to make these catastrophes worse. This is an essential issue for every element of

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[10] https://popular.info

[11] https://www.responsible-investor.com/articles/i-want-to-make-an-official-request-of-regulators-and-the-esg-community-stop-it

[12] https://www.epa.gov/homeland-security-waste/guidance-about-planning-natural-disaster-debris

corporate strategy, from supply chain issues to core operations and risk management." EPA also has a sustainability initiative[13] on better disclosure of investment risk.

2. A study published in *Sustainability Accounting, Management and Policy Journal* by Michael Magnan and Hani Tadros[14] found that better disclosure of environmental performance correlated with better performance at the 78 companies in environmentally sensitive industries that they examined.

> In this paper, we aim to bridge the gap in the literature about the association between environmental disclosure and environmental performance by analyzing the motivation of firms with high or low environmental performance to disclose proprietary environmental information that could compromise the firm's competitive position or have direct impact on its cash flow. Consistent with some prior research, we argue that economic- and legitimacy-based incentives both drive a firm's environmental disclosure. However, revisiting prior research, we put forward the view that a firm's environmental performance (either high or low) moderates the effects of these incentives on environmental disclosure in a differential fashion.

Of course, you do not have to be an economist to conclude that companies will be more transparent when there is good news to report. What matters here is what investors can conclude from the level of transparency in these disclosures, and what it means about the potential – or necessity – for engagement. We point the EBSA staff to the work of Tensie Whelan of NYU Stern Center for Sustainable Business on ESG data as a key indicator of supply chain risk, relating to the State Department release cited below.

3. The Bank of England takes note of climate-related investment risk:

> [A] speech by Sarah Breeden,[15] head of international banks supervision, suggests…that time is running out to prevent catastrophic climate change and previous efforts to combat the problem have been nowhere near vigorous enough.
>
> Breeden's message to the financial sector was that they need to incorporate climate change into their corporate governance, their risk management analysis, their forward planning and their disclosure policies or face the prospect of losing a heck of a lot of money.
>
> The financial markets have a term for a sudden drop in assets prices known as a Minsky moment (after the economist Hyman Minsky). Breeden said a climate Minsky moment was possible, in which losses could be as high as $20tn (£15.3tn).

If the Bank of England is calling on companies to address the risks of climate change, then the Department of Labor should recognize that pension fund managers' similar assessment of risk is consistent with their obligation as fiduciaries.

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[13] https://www.epa.gov/sites/default/files/2019-12/documents/esgmetricsreportingtemplate_pam_lacey.pdf
[14] https://www.emerald.com/insight/content/doi/10.1108/SAMPJ-05-2018-0125/full/html
[15] https://www.bankofengland.co.uk/-/media/boe/files/speech/2019/avoiding-the-storm-climate-change-and-the-financial-system-speech-by-sarah-breeden.pdf

4. A July 2020 report from GAO[16] documents the financial/"pecuniary" priority of institutional investors use of ESG factors in calculating investment risk. We incorporate that entire report by reference in this document. An excerpt:

> 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. Representatives at the other two pension funds said that they generally do not consider ESG information relevant to assessing companies' financial performance. While investors with whom we spoke primarily used ESG information to assess companies' long-term value, other investors also use ESG information to promote social goals. A 2018 US SIF survey found that private asset managers and other investors, representing over $3.1 trillion (of the $46.6 trillion in total U.S. assets under professional management), said they consider ESG issues as part of their mission or in order to produce benefits for society....
>
> These investors added that they use ESG disclosures to monitor companies' management of ESG risks, inform their vote at shareholder meetings, or make stock purchasing decisions. Most of these institutional investors noted that they seek additional ESG disclosures to address gaps and inconsistencies in companies' disclosures that limit their usefulness. [emphasis added, footnotes omitted]

Not one of the investors surveyed made any "pecuniary" trade-offs and the overwhelming majority look at ESG exclusively in financial terms.

5. Pensions and Investments[17] reported on an ISS study:

A link exists between a company's ESG performance and its financial performance, according to a study published from ISS ESG, the responsible investment arm of Institutional Shareholder Services.

Firms with high or favorable ISS ESG corporate ratings tend to be more profitable through an economic value-added lens, the study found.

> While one can argue that the relationship between ESG and financial performance is perhaps due to the fact that more profitable firms have the resources to invest in areas that positively influence ESG, it could also be that profitability rises as a result of a company better managing its material ESG risks, or it could be a little bit of both," the study said. "If it is a little bit of both, then this means that good-ESG initiatives drive up financial performance, which then provides the monetary resources to invest to be an even better ESG firm, which then drives up performance again, and so on.

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[16] https://www.gao.gov/assets/710/707949.pdf

[17] https://www.pionline.com/esg/iss-study-links-esg-performance-profitability

Moreover, companies with better ESG ratings are also less volatile, noted Anthony Campagna, global head of fundamental research at ISS EVA.

6. Corporations are increasingly providing ESG disclosures[18] to respond to investor demand and to assist in their own strategic planning, and those that do tend to outperform. Whether that is cause or effect is not clear, but for investment risk assessment purposes, that makes little difference.

Since July 2017, following the release of the Task Force on Climate Related Disclosure (TCFD) guidelines, more than 500 large businesses, investors and industry groups have signed on to provide this type of forward-looking financial disclosure. Companies in the financial services industry are leading the way in their support of the TCFD recommendations, including BlackRock, State Street and S&P Global, along with the Association of Chartered Certified Accountants.

It is not limited to the financial services industry. Other sectors are signing on, including Statoil and Shell in the energy sector, consumer product companies such as H&M and Nestlé, materials companies such as BASF and DowDuPont, as well as industrial companies such as Saint-Gobain and Ingersoll Rand.

7. On July 1, 2020 the U.S. Department of State, along with the U.S. Department of the Treasury, the U.S. Department of Commerce, and the U.S. Department of Homeland Security issued a business advisory to caution businesses about the risks of supply chain links to entities that engage in human rights abuses, including forced labor, in the Xinjiang Uyghur Autonomous Region (Xinjiang) and elsewhere in China. DOL/EBSA should not issue a rule that fundamentally undermines this critical policy advisory from four other Departments. EBSA should coordinate with the other federal agencies to ensure that pension fiduciaries are not discouraged from making the appropriate calculations about supply chain risk.

8. A new global alliance of financial institutions, investors and businesses,[19] is launching a new central source for accessible, digital, corporate sustainability information in support of the 10 principles of the UN's Global Compact.[20]

9. President Biden's wide-ranging initiatives on ESG issues include an Executive Order on Climate-Related Financial Risk.[21] As the Department is aware, it will impose new obligations and create new opportunities for assessing investment risk based on climate and other ESG factors.

> It is therefore the policy of my Administration to advance consistent, clear, intelligible, comparable, and accurate disclosure of climate-related financial risk (consistent with Executive Order 13707 of September 15, 2015 (Using Behavioral Science Insights to Better Serve the American People)), including both physical and transition risks; act to mitigate that risk and its drivers, while accounting for and addressing disparate impacts on

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[18] https://www.greenbiz.com/report/2019-state-green-business-report
[19] https://www.ft.com/content/304f9a1f-cb31-4c83-81bd-d814aa211c26
[20] https://www.unglobalcompact.org
[21] https://www.whitehouse.gov/briefing-room/presidential-actions/2021/05/20/executive-order-on-climate-related-financial-risk/

disadvantaged communities and communities of color (consistent with Executive Order 13985 of January 20, 2021 (Advancing Racial Equity and Support for Underserved Communities Through the Federal Government)) and spurring the creation of well-paying jobs; and achieve our target of a net-zero emissions economy by no later than 2050. This policy will marshal the creativity, courage, and capital of the United States necessary to bolster the resilience of our rural and urban communities, States, Tribes, territories, and financial institutions in the face of the climate crisis, rather than exacerbate its causes, and position the United States to lead the global economy to a more prosperous and sustainable future.

Another Executive Order focuses on creating opportunities for clean energy[22] that will affect the investment risk assessment in many sectors.

10. "ESG: Shareholder Engagement and Downside Risk"[23] finds that "successful engagement [on ESG factors] reduces the firm's exposure to a downside-risk factor."

11. In the Harvard Business Review article, An ESG Reckoning is Coming[24], Michael O'Leary and Warren Valdmanis write that companies have been better at promising to meet ESG goals than delivering on them, which underscores the vital importance of shareholder oversight to protect loss of shareholder value.

12. The SEC's Asset Management Advisory Committee recommended meaningful, consistent, and comparable disclosure of material environmental, social, and governance ESG disclosures earlier this year.[25] Increasing adoption of TCFD[26] and SASB[27] disclosure standards will provide critical information for all investors, including pension fiduciaries, to factor into their assessments of investment risk.

The Department already has not just the enforcement authority but the obligation to use it if a pension fiduciary makes an investment decision for any reason other than "the exclusive benefit of plan participants." There is a lot still to be determined about ESG and some arguments to be had over long-and short-term calculations, but it is always, always financial, and we appreciate EBSA's clarity on that point, in regulation and enforcement.

One more note: because of the widespread efforts to distort the rulemaking process through undisclosed financial ties between some of the groups and individuals filing comments, we want to make it clear that no one is paying us to comment on the proposed rule and neither we nor our clients have any financial interest that will be affected by this rule. This comment is based entirely

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[22] https://www.whitehouse.gov/briefing-room/presidential-actions/2021/12/08/executive-order-on-catalyzing-clean-energy-industries-and-jobs-through-federal-sustainability/

[23] https://www.researchgate.net/profile/Xiaoyan-Zhou-7/publication/318002428_ESG_Shareholder_Engagement_and_Downside_Risk/links/5e6769ce299bf1744f6f12f6/ESG-Shareholder-Engagement-and-Downside-Risk.pdf

[24] https://hbp.az1.qualtrics.com/CP/File.php?F=F_e4XeHWSIIMVXsRo

[25] https://www.sec.gov/files/amac-recommendations-esg-subcommittee-070721.pdf

[26] https://www.fsb-tcfd.org

[27] https://www.sasb.org

on our own views, based on more than 30 years in this field. To protect the quality of the notice and comment procedure, we recommend that the Department include in all future rulemakings language like this:

> We encourage commenters to state clearly whether they are directly or indirectly receiving payment or subsidies for submission of the comment and any financial ties they have to those who are likely to be affected by the rule. These disclosures are not required but failure to include them will be a factor in determining the credibility of the comments.

We will be reviewing other comments and will file additional materials if we believe there is something requiring a response. We are happy to provide further information or answer questions on any of the points made in this comment or issues presented by the proposed rule.

/s/

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