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

RE: RIN 1210–AC03, Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights

Ladies and Gentlemen:

Morningstar, Inc., Morningstar Investment Management, and Sustainalytics welcome the opportunity to comment on the proposed rule "Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights." In this letter, we will briefly outline why we support the proposal and offer some additional data to address some of the gaps in the Regulatory Impact Analysis.

Simply stated, unlike the 2020 "Financial Factors" regulation, the department's proposed rule is aligned with the common practices of asset managers and financial advisors who increasingly integrate environmental, social, and governance considerations into their investment processes and selections.

As we have argued before, ESG risk analysis should often be part of a prudent investment analysis—and not called out for special, unique scrutiny. Firms without a plan to cope with climate change, for example, may be caught flat-footed in the face of new regulation or environmental realities. Human capital management is not just about a plan participant's preferences, but about the reputational and regulatory risks that companies face if they have poor diversity and inclusion practices or labor relations. Many asset managers already integrate ESG factors into their analysis to evaluate issues like these, and with this proposal, the department explicitly acknowledges that ESG issues can be financially material.

In addition to managing ESG risks, many participants want investment options that better align with their values. When plans can offer such funds without sacrificing returns, they can attract participants who are more committed to their investments and therefore more likely to contribute regularly and stay the course over the long run. In creating a path for including such investments in a plan lineup, the proposal furthers the overall goal of enhancing U.S. retirement security.

Most importantly, the rule addresses the consideration of ESG in Qualified Default Investment Alternatives, which the current regulation makes extremely difficult and risky for plan sponsors to do. Because ESG analysis is so important for developing a view of the long-term sustainability of an investment, it should be included in the analysis of qualified default investment alternatives. An investment that most participants will use by default should at least consider the long-term risks associated with certain ESG practices that could impede an issuer's long-term ability to generate cash flows and profits.

Retirement Plans Already Use Investment Strategies That Incorporate ESG Analysis, Demonstrating the Need for Regulatory Clarity

In the next two sections, we provide additional evidence beyond that which we provided in our 2020 comment or that the department has cited. This supplemental evidence may help fill in gaps in the Regulatory Impact Analysis.

As many as 36% of large retirement plans (defined as having more than 100 participants) already offer strategies that use ESG analysis to evaluate investments but would benefit from the legal clarifications the DOL proposes. Although the department uses 9% of plans using ESG-inflected strategies as a best guess in the regulatory impact analysis, we believe the true number is quite a bit higher, at least among plans with more than 100 participants.

Part of the difference in estimates may result from using different definitions of ESG. We begin our analysis by generating a list of funds as of 2019 that use Morningstar's broadest definition of ESG, which includes any fund with a prospectus that references considering ESG information for selecting securities. We then match those funds to data in the publicly available information on the 2019 Form 5500, which results in the finding that 36% of plans with more than 100 participants offer at least one fund with an ESG component. We believe this percentage is almost certainly higher today as actively managed funds increasingly reference ESG analysis in their prospectuses. Furthermore, due to data limitations in the Form 5500—which the department discusses in recent proposed rule-making to improve the quality of the 5500 filings—this percentage is probably an underestimate of the true number of plans using investment strategies that incorporate ESG analysis.[1]

As the department already notes in the impact analysis, these plans may not be able to fully explore how these funds use ESG analysis for fear of running afoul of the 2020

[1] We can only match around 2.7 trillion in assets listed on the schedule H (among filers in 2020) to our database of ESG strategies.

"Financial Factors" rule, harming participants. Therefore, we believe the rule would have a positive effect on many more plans than the department currently anticipates.

The Regulatory Impact Analysis Conflates Socially Responsible Strategies With Those Who Use ESG Analysis to Maximize Risk-Adjusted Returns

The regulatory impact analysis discusses studies that point to the financial materiality of ESG information, as well as some studies that purport to show that ESG investing underperforms conventional strategies. The studies that the department cites showing underperformance are all rooted in a negative screening or socially responsible investing context, while most plan sponsors (except for those using the tiebreaker test) would use a modern, financially material ESG lens to select investments. In contrast, most of the studies that the department cites showing ESG analysis has potentially boosted returns define ESG primarily or solely to maximize risk-adjusted returns. That is not to say a plan sponsor could not identify a strategy that uses negative screening, which the sponsor believes will perform as well as an alternative using the tiebreaker test. However, we believe most sponsors will integrate ESG factors into their investment process to maximize risk-adjusted returns, and there is scant evidence that such an approach has resulted in underperformance.

Public retirement plans—such as New York City Employees' Retirement System and the New York City Teachers' Retirement System, which the department already cites—provide a useful case study. While these are public defined-benefit plans, analyzing them demonstrates plans that have committed to using financially material ESG information in their investment decisions have delivered strong returns to their participants, though there is more mixed evidence among those plans committed only to negative screening or other nonfinancial mandates.

The New York plans the department cites—along with a number of other large Pension Plans—have signed the Principles for Responsible Investment, meaning among other things, they have committed to incorporate ESG issues into investment analysis and decision-making processes. Over the past five years, the plans have delivered a 10% and 10.1% annual return, respectively, according to data from the Boston Retirement Research Center.[2] These returns compare favorably with the 8.2% returns earned on average over 10 years by all plans that the data set track.[3] On the flip side, researchers have found that when ESG is defined to include socially responsible strategies that may be nonfinancially material, public plans may perform worse than average if they employ such strategies.[4]

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[2] "Public Plans Data." 2001-20. Center for Retirement Research at Boston College, MissionSquare Research Institute, and National Association of State Retirement Administrators.

[3] See data on https://publicplansdata.org/quick-facts/national/#investments accessed on Nov 2, 2021.

[4] Aubry, Jean-Pierre, Anqi Chen, Patrick M. Hubbard, and Alicia H. Munnell. ESG Investing and Public Pensions: An Update. No. 74. Center for Retirement Research, 2020.

Again, we applaud the department for taking this important step to provide legal clarity on using ESG considerations in selecting plan investments. We offer this letter to provide additional evidence to support the department's efforts.

Very truly yours,

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