The SPARK Institute, Inc.
SHAPING AMERICA'S RETIREMENT

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

Dear Sir or Madam:

On behalf of the SPARK Institute, Inc., we are writing in support of the amendments proposed by the Department of Labor (the "Department") to the "Investment Duties Regulation" under the Employee Retirement Income Security Act of 1974 ("ERISA").[1]

The SPARK Institute represents the interests of a broad-based cross section of retirement plan service providers and investment managers, including banks, mutual fund companies, insurance companies, third party administrators, trade clearing firms, and benefits consultants. Collectively, our members serve approximately 100 million employer-sponsored plan participants.

Overall, the SPARK Institute supports the proposed changes to the Investment Duties Regulation because they would eliminate the current regulatory provisions that are likely to discourage some fiduciaries from selecting investments that consider the effects of climate change and other environmental, social, or governance ("ESG") factors, even when such investments may ultimately be in the best interest of participants. As we have stated in previous comments to the Department, many of the factors that investment managers use in making investment decisions, some of which could be called ESG factors, are material to the risk-return profile of certain investments. Accordingly, these factors can be appropriately considered in fulfilling a fiduciary's obligations under ERISA. As is the case with all investment decisions, a plan fiduciary must not subordinate the interests of participants and beneficiaries in their retirement income or financial benefits under the plan to collateral goals. In many cases, ESG factors are not collateral.

[1] 86 Fed. Reg. 57272 (Oct. 14, 2021).

The SPARK Institute believes that the Department's proposed changes would move the fiduciary standards reflected in the Department's regulations much closer to traditional understandings of ERISA's fiduciary duties of prudence and loyalty. As we discussed in our previous comments to the Department in response to its amendments proposed in 2020, we believe that some of the provisions included in the current Investment Duties Regulation interfere with, rather than promote a prudent fiduciary process, and we commend the Department for proposing changes, as noted below, that would eliminate many of these unnecessary interferences.

I. COMMENTS ON GENERAL CHANGES TO PRUDENCE AND LOYALTY STANDARDS

ESG Factors Are Relevant to Risk/Return. Under the Department's proposal, the Investment Duties Regulation would be amended to clarify that "appropriate consideration" of the projected return of an investment or investment course of action "may often require an evaluation of the economic effects of climate change and other environmental, social, or governance factors on the particular investment or investment course of action."[2] The SPARK Institute generally supports this clarification because, as discussed above, we believe that the effects of climate change and other ESG factors may be material to the risk-return profiles of certain investments. Although the current Investment Duties Regulation does not prohibit a prudent fiduciary from considering these types of factors, assuming that they have a "pecuniary" impact, we believe that the current regulation is likely to discourage some fiduciaries from considering ESG factors, even when it is otherwise appropriate and serves the best interest of plan participants and beneficiaries. The SPARK Institute believes that the proposed clarification referenced above will help to neutralize the treatment of ESG factors relative to non-ESG factors in a way that is consistent with long-accepted fiduciary norms.

Remove Reference to "Often." Although we support clarifying that ESG factors may be appropriately considered along with any other factors an investment manager or fiduciary determine to be relevant to a particular investment or investment course of action, we do not believe it is necessary to state in the regulation that this is "often" the case, and doing so may be counterproductive. Whether a particular factor is or is not relevant to a course of action is based on all the facts and circumstances, which includes the investment strategy being pursued. Moreover, ERISA's fiduciary prudence standard depends on the "circumstances then prevailing" and thus the Investment Duties Regulation should be written in a way that is durable. Unless the Department can support its reference to "often" with empirical data, we do not believe that the Department should be expressing a view on the frequency with which a fiduciary may be required to consider the effects of climate change and other ESG factors.

Specific List of ESG Factors. Although the SPARK Institute supports the proposed amendments that would generally recognize the appropriateness of evaluating investments with regard to the economic effects of climate change and other ESG factors, our members have mixed reactions to the proposed amendments that would provide a specific list of climate change

[2] Proposed Labor Regulation section 2550.404a-1(b)(2)(ii)(C).

and other ESG factors that a prudent fiduciary may consider in the evaluation of an investment or investment course of action.

Some of our members support the list's inclusion in the text of the regulation itself because the proposed examples include ESG factors that are material to the risk-return profile of certain investments, and the examples are consistent with the investment philosophies of many of our members. While these members would appreciate additional clarification that the proposed list is merely illustrative and not exhaustive, they otherwise support the list's inclusion in the regulation.

Other SPARK members, however, have concerns with the list of ESG factors that would be added under Labor Regulation section 2550.404a-1(b)(4), as proposed, and would like to see the list removed from the text of the regulation. While this group is concerned with the list's inclusion in the text of regulation itself, many of these firms would support a discussion of the list of ESG factors, or a similar list of examples, in the preamble to the Department's final regulation. We have primarily heard three concerns from this group:

- First, there is a concern that the list could be interpreted as limiting a fiduciary's evaluation of factors that have not traditionally been considered material to the risk-return of an investment to the list that is expressly enumerated in the regulation. These concerns are informed by member experiences with other regulatory examples that, notwithstanding their illustrative nature, become a de facto requirement or safe harbor when applied in the ordinary course of their businesses.
- Second, there is a concern that, as the consideration of ESG evolves, the Department's list could become outdated – whether by failing to recognize a factor that is widely understood as material to the risk-return of an investment or by including a factor that is no longer recognized as an appropriate consideration for fiduciaries.
- Third, because the proposal offers a specific list of examples, as opposed to a description of general principles, there is a concern that the list could make the regulation more likely to be challenged by a future administration.

Tie-Breaker Test. The Department's proposal would generally reframe and simplify the tie-breaker test that is contained in the current Investment Duties Regulation. The SPARK Institute supports these changes.

- Application. The tie-breaker test described in the Department's proposal indicates that, after a fiduciary has evaluated an investment or investment course of action based on risk and return factors, the fiduciary is not prohibited from selecting an investment or investment course of action based on collateral benefits other than investment returns, if such fiduciary "prudently concludes that competing investments, or competing investment courses of action, *equally serve the financial interests of the plan over the appropriate time horizon* (emphasis added)."[3]

The SPARK Institute supports the Department's proposed formulation of the tie-breaker

[3] Proposed Labor Regulation section 2550.404a-1(c)(3).

test because it more accurately reflects the realities of fiduciary decision-making than the tie-breaker test that is described in the Department's current regulation. Under the current regulation, the tie-breaker test may only apply to a fiduciary "when choosing between or among investment alternatives that the plan fiduciary is unable to distinguish on the basis of pecuniary factors alone."[4] The SPARK Institute believes that the current tie-breaker test improperly limits its application because it would only apply when a fiduciary is unable to distinguish two or more investments based on pecuniary factors alone – an occurrence that is seldom to occur and unreasonably difficult to identify. In the real world, a prudent fiduciary process often produces a variety of investments that are consistent with, and will in the fiduciary's judgement equally promote, the financial interests of participants and beneficiaries.

- <u>Elimination of Special Documentation.</u> The current Investment Duties Regulation imposes a special documentation requirement on plan fiduciaries that use ESG and other collateral benefits to choose among investments that are otherwise indistinguishable based on pecuniary factors.[5] The proposed Investment Duties Regulation would completely eliminate this special documentation requirement.

  The SPARK Institute supports the elimination of the special documentation requirement for plan fiduciaries that use ESG and other collateral benefits to choose among investments and investment courses of action that equally serve the financial interests of the plan over the appropriate time horizon. We agree with the Department's assessment in the preamble to the proposal indicating that ERISA's general prudence obligation, including any associated requirement to document key decisions, is sufficiently protective of the interests of plan participants and beneficiaries, and a regulatory documentation requirement that is specific to the tie-breaker test is unnecessary.

New Collateral-Benefit Disclosure. Under the proposed regulation, if a plan fiduciary selects a designated investment alternative ("DIA") based in part on the collateral benefits that it creates, the plan fiduciary must prominently disclose the "collateral-benefit characteristic of the fund, product, or model portfolio" in disclosure materials provided to participants and beneficiaries.[6]

The SPARK Institute opposes this proposed disclosure because it would disproportionately emphasize one part of the fiduciary decision-making process over other more relevant factors in a way that could mislead participants and impact participant choices in ways that are unintended by the Department. For example, if a plan fiduciary narrows the possible universe of DIAs down to a small group of investments that equally serve the financial interests of the plan and selects a particular investment – "Fund X" – because it is the only option that discusses ESG factors as part of its investment objectives, the proposal would require the plan

[4] Current Labor Regulation section 2550.404a-1(c)(2).

[5] Current Labor Regulation section 2550.404a-1(c)(2).

[6] Proposed Labor Regulation section 2550.404a-1(c)(3).

fiduciary to prominently disclose the ESG characteristic to participants. This is true even if ESG considerations only played a small role in the fiduciary's overall selection of the investment. This is also true even if ESG factors are given less weight in Fund X's overall portfolio than the weight given to such factors in the portfolios of other DIAs. The plan might, for example, also offer a DIA – "Fund Y" – that was selected exclusively based on its risk-return profile, but Fund Y places significantly more weight on ESG factors than Fund X. Notwithstanding this disparity, Fund X would be prominently labeled as an ESG fund to participants and Fund Y would not. In this regard, the proposed disclosure would emphasize only one portion of a fiduciary's selection process over the fundamental objectives of the investment itself. This may mislead participants and inappropriately impact the selection of investments by participants who may rely on the special disclosure to invest in, or avoid, DIAs that promote collateral benefits.

The Department already has in place thoughtful and detailed rules on the disclosures that should be provided to participants who have the ability to direct their own investments. We think that those current rules, described in Labor Regulation section 2550.404a-5, appropriately inform participants about their investment options and the Department should not add to those disclosures in the way that would be required by the Department's proposal.

Notwithstanding our overall objection to the proposed collateral-benefit disclosure, if such disclosure is retained in the final rule, we urge the Department to address the following concerns:

- Guidance on Disclosure Location. The SPARK Institute encourages the Department to offer additional suggestions for ways that fiduciaries may add the collateral-benefit characteristic to other relevant disclosures. While the proposed regulation does not specify where such disclosure must be made, the preamble to the Department's proposal indicates that one likely way to satisfy the requirement would be for plan fiduciaries to disclose the collateral-benefit characteristic in the disclosure required by Labor Regulation section 2550.404a-5 (the "404a-5 disclosure"). Our concern with the example pointing to the 404a-5 disclosure is that retirement plan recordkeepers, who typically program and deliver the 404a-5 disclosure on behalf of the plan fiduciary, are most often not the fiduciary responsible for determining the DIAs that will be made available through the plan's menu. Accordingly, plan service providers preparing the 404a-5 disclosure will not necessarily know which funds have been chosen based on collateral benefits and which funds have been chosen exclusively for their risk-return characteristics.

- Guidance on Prominent Display. The SPARK Institute requests that the Department provide additional clarification on what it means for the new disclosure to be "prominently" displayed. We are concerned that this could be interpreted to mean that the disclosure must be more prominent than other information which is more critical to participant decision-making, such as the asset class, historical return, or fees of the investment. We would ask the Department to confirm that so long as the new disclosure is as prominent as other required disclosures in the 404a-5 disclosure, this is sufficient. This should include, for example, clarification that the collateral-benefit disclosure may be satisfied if it appears on the website that the 404a-5 rules prescribe for disclosing detailed information about DIAs, including each DIA's objectives, goals, and principal strategies.[7]

- Examples of Collateral-Benefit Characteristics. As part of the final rule, we also request that the Department provide a list of examples that may be used to describe "collateral-benefit characteristics".

Current Prohibition on QDIAs with ESG Objectives. Under the Department's current regulation, a plan fiduciary is prohibited from adding or retaining a qualified default investment alternative ("QDIA") if its investment objectives or goals or its principal investment strategies include, consider, or indicate the use of one or more non-pecuniary factors.[8] The Department's proposal would eliminate this prohibition.

The SPARK Institute supports this proposed change. During last year's rulemaking, the SPARK institute expressed strong concerns with this blanket prohibition because, among other issues, it: (1) could bar an investment selected after an otherwise prudent process; and (2) would inappropriately subject QDIAs to a higher level of fiduciary oversight than other DIAs. We continue to have strong concerns with the current regulation's prohibition on QDIAs with collateral objectives and commend the Department for acting to remove this unnecessary restriction.

Duty of Loyalty. As the SPARK Institute described in its comments responding to the Department's 2020 ESG proposal, we believe that ERISA permits a prudent fiduciary to consider factors that do not have a material effect on the risk and/or return of an investment, *provided that the consideration of such factors is consistent with the fiduciary's duties of prudence and loyalty*. As we previously discussed, these factors could include, for example: a fund manager's brand or reputation; the number of investments already available on the plan menu; operational considerations that may have a bearing on fees or administrative/operational burdens; an investment's regulatory regime; active versus passive management; whether an investment's disclosures are easier for participants to understand; and participant preferences that may increase plan participation. In a similar regard, a prudent plan fiduciary might also consider the collateral benefits of using proprietary funds or employer stock in a plan's investment lineup, in addition to the risk-return profile of such investments.

Although we support the proposed changes that would strike language generally indicating that "[a] fiduciary's evaluation of an investment or investment course of action must be based only on pecuniary factors," we do not believe that the proposed changes go far enough to recognize the potential consideration of the types of additional factors referenced in the preceding paragraph. For example, the proposal would still state that "[a] fiduciary's evaluation of an investment or investment course of action must be based on risk and return factors that the fiduciary prudently determines are material to investment value . . ." While we believe that risk-

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[7] *See* Labor Regulation section 2550.404a-5(d)(1)(v).

[8] Current Labor Regulation section 2550.404a-1(d)(2)(ii).

return factors should be of primary importance in any fiduciary decision, and fiduciaries should not be permitted to subordinate participant interests in support of any benefits or goals unrelated to the interests of participants and beneficiaries, the Department could improve its proposal by expressly clarifying that a prudent fiduciary may also consider the kinds of factors described in the preceding paragraph.

In order to address the proposal's shortcomings with regard to these considerations, we request that the Department add the following clarification to section (c)(2) of its proposed regulation: "The requirements of this paragraph (c) do not prohibit a fiduciary from considering factors that do not directly affect the risk-return of an investment or investment course of action, provided that the consideration of such factors is made as part of a process that is consistent with ERISA's fiduciary duties of prudence and loyalty."

II. COMMENTS ON CHANGES TO PROXY VOTING STANDARDS

Transition Relief for Pooled Investments. The proposal provides that in the case of a pooled investment, "the investment manager must vote (or abstain from voting) the relevant proxies to reflect such policies in proportion to each plan's economic interest in the pooled investment vehicle."[9] The proposal then goes on to state that "an investment manager may, however, develop an investment policy statement consistent with Title I of ERISA and this section, and require participating plans to accept the investment manager's investment policy statement, including any proxy voting policy, before they are allowed to invest."[10] In our experience, very few managers of pooled investments would be willing to vote proxies based on the policies of investing plans, so the vast majority already do or will require participating plans to accept the investment manager's policy. However, because not all investment managers may have received this consent when the initial investment was made, we recommend that the Department clarify that an investment manager could obtain consent via negative consent, i.e., sending a written notification to participating plans which states that continued investment constitutes acceptance of the investment policy and proxy voting policy.

Special Recordkeeping and Monitoring Requirements. The current Investment Duties Regulation expressly requires fiduciaries to maintain records on proxy voting activities and other exercises of shareholder rights.[11] In a similar regard, the current Investment Duties Regulation includes a specific monitoring obligation where the authority to vote proxies or exercise shareholder rights has been delegated to an investment manager or where a proxy voting firm performs advisory services as to voting proxies.[12]

The SPARK Institute supports the elimination of these specific requirements in the text of the Investment Duties Regulation. We believe that ERISA's duty of prudence already reflects

[9] Proposed Labor Regulation section 2550.404a-1(d)(4)(ii).

[10] *Id.*

[11] Current Labor Regulation section 2550.404a-1(e)(2)(ii)(E).

[12] Current Labor Regulation section 2550.404a-1(e)(2)(ii)(F).

a general duty to monitor plan service providers and a general duty to keep records of fiduciary decisions, as appropriate. The additional regulatory requirements included in the current regulation are unnecessary and could mislead fiduciaries into believing that there is some additional monitoring and/or recordkeeping obligation that is specific to the exercise of shareholder rights.

III. APPLICABILITY DATE & TRANSITION RELIEF

The Department's proposal would delete the applicability dates that were added as part of its most recent amendments to the Investment Duties Regulation under the Trump Administration. The Department's proposal does not, however, include new applicability dates for its currently proposed changes.

The SPARK Institute requests that, as part of any final rule, the Department provide a prospective applicability date for all of its recent changes to the Investment Duties Regulation. The prospective applicability date should apply equally to the changes that were finalized at the end of the Trump Administration and the changes that are being proposed under the Biden Administration. At the very least, the Department should provide a prospective effective date for all of its recent changes that is no earlier than the date that is one year after the Department's final amendments are published in the Federal Register.

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The SPARK Institute appreciates the opportunity to provide these comments to the Department. If the Department has any questions or would like more information regarding our comments, please contact me or the SPARK Institute's outside counsel, Michael Hadley, Davis & Harman LLP (mlhadley@davis-harman.com).

Sincerely,

Tim Rouse
Executive Director